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# The Director's Duty of Care Three Years After *Smith v. Van Gorkom*

by  
Stephen A. Radin\*

Three years ago, the Delaware Supreme Court shocked the corporate world by holding in *Smith v. Van Gorkom*<sup>1</sup> that a board of directors had been grossly negligent in approving a cash-out merger proposal that assured shareholders a 39 to 62 percent premium (depending upon the method of calculation)<sup>2</sup> over market price, and that their decision was not sufficiently informed to merit business judgment rule protection.<sup>3</sup> The court's three-to-two opinion was labeled a "comedy of errors" by one of the dissenting justices,<sup>4</sup> and extensive commentary, much of which "predict[ed] dire consequences,"<sup>5</sup> quickly filled both general media publications<sup>6</sup> and legal newspapers and journals.<sup>7</sup> Observers attacked the de-

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1. 488 A.2d 858 (Del. 1985).

2. *Id.* at 869 n.9; *see infra* note 68.

3. *Id.* at 874.

4. *See id.* at 894 (McNeilly, J., dissenting).

5. Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 (1985).

6. *See* Baldo, *Delaware Rocks the Boat*, FORBES, Apr. 8, 1985, at 126; Leisner, *Boardroom Jitters: A Landmark Court Decision Upsets Corporate Directors*, BARRON'S, Apr. 22, 1985, at 34; *A Landmark Ruling that Puts Board Members in Peril*, BUS. WK., Mar. 18, 1985, at 56 [hereinafter *A Landmark Ruling*]; *No More Easy Street for Company Directors*, U.S. NEWS & WORLD REP., Mar. 4, 1985, at 95; *On the Boards Directors Face Tougher Scrutiny*, TIME, Feb. 11, 1985, at 69.

7. *See* 1 R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.7, at 99-105 (1988); Borden, *First Thoughts on Decision in Delaware on Trans Union*, N.Y.L.J., Feb. 25, 1985, at 1, col. 3; Burgman & Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the Trans Union Case*, 11 J. CORP. L. 311 (1986); Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505 (1985); Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985); Herzel, Davis & Colling, *"Smith" Brings Whip Down on Directors' Backs*, LEGAL TIMES OF WASHINGTON, May 13, 1985, at 14; Herzel & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Kirk, *The Trans Union Case: Is It Business Judgment as Usual?*, 24 AM. BUS. L.J. 467 (1986); Manning, *supra* note 5; Middleton, *Merger Decision Lawyers See Warning in Court's View of Business Judgment Standard*, 23 NAT'L L.J., Feb. 18, 1985, at 8, col. 1; Moskin, *Trans*

cision as "dumbfounding" and a "serious mistake,"<sup>8</sup> "one of the worst decisions in the history of corporate law,"<sup>9</sup> and "a distinct threat to the ability of companies to attract responsible directors."<sup>10</sup> Judge Richard A. Posner of the Seventh Circuit Court of Appeals observed that the decision has been criticized "so forcefully and cogently" that he "hesitate[d] to conclude" that Indiana would follow *Van Gorkom*.<sup>11</sup> Despite the fact that "in matters of corporation law the Indiana courts normally take their cue from the Delaware courts, which are more experienced in such matters."<sup>12</sup> Particularly startling to many was the dramatization that individuals serving on corporate boards could be held liable for monetary damages for conduct undertaken in good faith.<sup>13</sup>

In the ensuing three years, state and federal courts<sup>14</sup> have grappled

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Union: *A Nailed Board*, 10 DEL. J. CORP. L. 405 (1985); Prickett, *An Explanation of Trans Union To "Henny-Penny" and Her Friends*, 10 DEL. J. CORP. L. 451 (1985); Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465 (1985); Schwartz & Wiles, *Business Judgment Rule Clarified by Delaware's Trans Union Decision*, NAT'L L.J., July 8, 1985, at 42, col. 3; Schwartz & Wiles, *Trans Union: Neither "New" Law Nor "Bad" Law*, 10 DEL. J. CORP. L. 429 (1985); Veasey, *Further Reflections on Court Review of Judgments of Directors: Is the Judicial Process Under Control?*, 40 BUS. LAW. 1373 (1985); Veasey & Seitz, *The Business Judgment Rule in the Revised Model Act, The Trans Union Case and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483 (1985); Note, *Corporations—Directors Who Approve Sale of Corporation Without Sufficient Deliberation Not Entitled to Protection Afforded by Business Judgment Rule*—Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), 16 SETON HALL L. REV. 242 (1986); Comment, *Mining the Safe Harbor? The Business Judgment Rule After Trans Union*, 10 DEL. J. CORP. L. 545 (1985).

Even J.W. Van Gorkom, the central figure in the case, has published commentary on the decision. See Van Gorkom, *The 'Big Bang' for Director Liability: The Chairman's Report*, DIRECTORS & BOARDS 17 (Fall 1987).

8. Herzel, Davis & Colling, *supra* note 7, at 14, 15.

9. Fischel, *supra* note 7, at 1455.

10. Borden, *supra* note 7, at 4, col. 4; see also 1 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, § 4.7, at 102 ("[t]he decision has sparked harsh criticism, even incredulity"); Manning, *supra* note 5, at 1 ("[t]he corporate bar generally views the decision as atrocious").

11. Dynamics Corp. of Am. v. CTS Corp. (CTS II), 805 F.2d 705, 711 (7th Cir. 1986); Comment, *Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interests and the Business Judgment Rule*, 24 HARV. J. ON LEG. 526, 526, 530-31 (1987) ("*Van Gorkom* sent a shockwave across corporate America, . . . provoked immediate and sharp criticism from members of the corporate bar, and was seen by some as the demise of the business judgment rule") (footnotes omitted).

12. *Id.* at 708.

13. See, e.g., Borden, *supra* note 7, at 4; Fischel, *supra* note 7, at 1453-54; Herzel, Davis & Colling, *supra* note 7, at 14; Note, *supra* note 7, at 273; *A Landmark Ruling*, *supra* note 6, at 56.

14. The law governing the internal affairs of a corporation, including the duty of care, the business judgment rule, and other corporate governance issues, is the law of the state of incorporation. See, e.g., CTS Corp. v. Dynamics Corp. of Am., 107 S. Ct. 1637, 1649-50 (1987); Brown v. Ferro Corp., 763 F.2d 798, 802-03 (6th Cir.), cert. denied, 474 U.S. 947 (1985); McDermott, Inc. v. Lewis, 531 A.2d 206, 214-19 (Del. 1987); Hart v. General Motors Corp.,

with the issue of directorial care and the implications of *Smith v. Van Gorkom* in a total (as of the end of 1987) of twenty-four cases.<sup>15</sup> The resulting body of case law demonstrates that the reports of the business judgment rule's demise were, like those of Mark Twain's death, exaggerated.<sup>16</sup> Six post-*Van Gorkom* cases have held that directors failed to exercise informed business judgment,<sup>17</sup> but—like *Van Gorkom*—each of these cases involved egregious facts. The cases are characterized by hasty and typically late-night or telephonic decisions that preempted the workings of the marketplace in situations in which the courts did not consider time to be of the essence, without the directors' studying the terms of the transaction or asking what the courts viewed as simple questions.

Moreover, with the exception of *Van Gorkom*, these findings have arisen in the context of requests for injunctive relief, and not in settings in which courts faced the prospect of imposing monetary damages upon individual directors. Statutes enacted in Delaware and twenty-seven other jurisdictions since *Van Gorkom* allow shareholders of individual corporations to determine by certificate of incorporation provisions whether they wish to eliminate or limit the possibility that directors will be held liable for monetary damages in cases involving good faith duty of care violations. Statutes enacted in five additional states increase the standard of culpability required to find liability on the part of directors of all corporations chartered in those jurisdictions.

This Article examines these post-*Van Gorkom* developments. Section I introduces the basic elements of the duty of care and the business judgment rule,<sup>18</sup> and section II reviews the Delaware Supreme Court's opinion in *Van Gorkom*.<sup>19</sup> Section III analyzes the post-*Van Gorkom* decisions that have upheld or struck down board conduct, focusing on

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129 A.D.2d 179, 182-85, 517 N.Y.S.2d 490, 492-94 (N.Y. App. Div.), *leave to appeal denied*, 70 N.Y.2d 608, 521 N.Y.S.2d 225 (1987).

15. The twenty-nine written opinions generated by the courts in these twenty-four cases are catalogued on a state-by-state basis, in accordance with the law governing each case, in the Appendix following this Article.

16. See OXFORD DICTIONARY OF QUOTATIONS 554 (3d ed. 1979).

17. See *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273-83 (2d Cir. 1986); *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 885-86 (6th Cir. 1986); *Dynamics Corp. of Am. v. CTS Corp.* (CTS I), 794 F.2d 250, 257-59 (7th Cir. 1986); *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209, 230-31 (S.D. Ohio), *aff'd mem.*, 815 F.2d 76 (6th Cir. 1987); *Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,331, at 96,682-83 (Del. Ch. July 20, 1987); *EAC Indus., Inc. v. Frantz Mfg. Co.*, 11 DEL. J. CORP. L. 608, 620 (Del. Ch.), *aff'd on other grounds*, 501 A.2d 401 (Del. 1985).

18. See *infra* notes 22-47 and accompanying text.

19. See *infra* notes 48-81 and accompanying text.

the factors relied upon by the courts deciding these cases.<sup>20</sup> Finally, section IV addresses state legislative efforts to reduce the likelihood that directors of corporations chartered in those jurisdictions will be held liable for monetary damages.<sup>21</sup>

### I. The Duty of Care and the Business Judgment Rule<sup>22</sup>

Corporate directors owe fiduciary duties to the corporation they serve and its shareholders. These fiduciary duties include the duty of care and the duty of loyalty. The duty of care requires that directors exercise the care that an ordinarily prudent person would exercise under similar circumstances; the duty of loyalty prohibits faithlessness and self-dealing.<sup>23</sup> A director who performs his duties in compliance with his duties of care and loyalty will not be held liable for his conduct as a director.<sup>24</sup>

The business judgment rule is a specific application of the directorial standard of conduct to the situation in which, after reasonable investigation, disinterested directors adopt a course of action that, in good faith, they honestly and reasonably believe will benefit the corporation. Should the directors be sued by shareholders because of their decision, a reviewing court—at least in theory—will not second-guess the merits of the decision, but will examine the decision only to the extent necessary to verify the presence of the rule's five elements: a business decision, disinterestedness, due care, good faith, and no abuse of discretion.<sup>25</sup>

*A Business Decision.* The business judgment rule has no applicability absent directorial action in the form of a business judgment or decision. Directorial inaction does not fall within the rule's safe harbor

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20. See *infra* notes 82-266 and accompanying text.

21. See *infra* notes 267-355 and accompanying text.

22. The following discussion is derived from D. BLOCK, N. BARTON & S. RADIN, *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS* 1-17, 24-25 (1987).

23. See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984).

24. REVISED MODEL BUSINESS CORP. ACT, *supra* note 23, § 8.30(d), comment at 224. The converse, however, is not true. A director who fails to comply with the applicable standard of conduct will not necessarily be held liable because the degree of culpability required for the imposition of liability may be higher than the standard of conduct. See Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 614 (1984); Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1479 (1984).

25. See D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 2; see also 1 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, § 4.6A, at 73-74; Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111-12 (1979).

unless it is the result of a conscious decision not to act.<sup>26</sup>

*Disinterestedness.* The duty of loyalty mandates that directors "possess a disinterested independence and . . . not stand in a dual relation which prevents an unprejudicial exercise of judgment."<sup>27</sup> In the words of the Delaware Supreme Court in *Pogostin v. Rice*:<sup>28</sup>

Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders. The question of independence flows from an analysis of the factual allegations pertaining to the influences upon the directors' performance of their duties generally, and more specifically in respect to the challenged transaction.<sup>29</sup>

The business judgment rule will not be rendered inapplicable if one director has a personal interest in a challenged transaction; rather, a majority of the corporation's directors must be engaged in self-dealing.<sup>30</sup>

*Due Care.* The duty of care requires that directors must exercise due care—defined as the care that an ordinarily prudent person would exercise under similar circumstances—in making a business decision, and the business judgment rule accordingly shields only "informed" decisions from judicial second-guessing.<sup>31</sup> As the Second and Seventh Circuits have stated, "directors are protected to the extent that their actions evidence their business judgment," but such protection "assumes that courts must not reflexively decline to consider the content of their 'judgment' and the extent of the information on which it is based."<sup>32</sup> In Delaware, the standard for determining whether a business judgment is an informed one is "gross negligence."<sup>33</sup>

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26. See, e.g., *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 275 (2d Cir. 1986); *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984); *Rabkin v. Philip A. Hunt Chem. Corp.*, No. 7547, slip op. at 24 (Del. Ch. Dec. 4, 1986) (LEXIS, States library, Del. file), *motion for reargument denied*, No. 7547, slip op. (Del. Ch. Dec. 17, 1987) (LEXIS, States library, Del. file); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971).

27. *Auerbach v. Bennett*, 47 N.Y.2d 619, 631, 393 N.E.2d 994, 1001, 419 N.Y.S.2d 920, 927 (1979).

28. 480 A.2d 619 (Del. 1984).

29. *Id.* at 624.

30. *Id.* at 626; *Aronson*, 473 A.2d at 812.

31. See, e.g., *Hanson*, 781 F.2d at 274-75; *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

32. *Hanson*, 781 F.2d at 275 (emphasis in original), *quoted in* *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886 (6th Cir. 1986).

33. See, e.g., *Van Gorkom*, 488 A.2d at 872-73; *Aronson*, 473 A.2d at 812 & n.6; *Rabkin v. Philip A. Hunt Chem. Corp.*, No. 7547, slip op. at 18 (Del. Ch. Dec. 4, 1986) (LEXIS, States library, Del. file); *Repairman's Serv. Corp. v. National Intergroup, Inc.*, 10 DEL. J. CORP. L. 902, 909 (Del. Ch. 1985); *cf.* *Rabkin v. Philip A. Hunt Chem. Corp.*, No. 7547, slip op. at 7-8 (Del. Ch. Dec. 17, 1987) (LEXIS, States library, Del. file) (concluding that "ordi-

*Good Faith.* The business judgment rule also requires that directors act with a good faith belief that their business judgment is in the best interests of the corporation. Good faith involves all aspects of honesty and integrity, and presupposes no personal financial interest or self-dealing. Directorial action must be genuinely motivated by an honest desire to benefit the corporation's shareholders, and not by some other purpose such as personal gain.<sup>34</sup>

*No Abuse of Discretion.* Even when the above four factors are present, a board decision will be respected by the courts only absent an abuse of discretion.<sup>35</sup> Accordingly, "a decision by disinterested directors following a deliberative process may still be the basis for liability if such decision cannot be 'attributed to any rational business purpose,' or is 'egregious.'"<sup>36</sup> As the Third Circuit has described this rule, "where [a] shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the director's sound discretion, a court should . . . be able to conduct its own analysis of the reasonableness of that business judgment."<sup>37</sup> The abuse of discretion concept, of course, "presupposes discretion, a term which reaffirms the broad latitude granted to the directors."<sup>38</sup> It is accordingly only the very rare case—"a possibility—perhaps more theoretical than real"<sup>39</sup>—in which the business judgment rule protection is denied due to an abuse of discretion. Such a case almost certainly must involve a waste of corporate assets, a cause of action separate and apart from a breach of fiduciary duty,<sup>40</sup> which requires a showing that the consideration received by the corporation was so inadequate in value that "no person of ordinary, sound business judgment would deem it worth that which the corporation paid."<sup>41</sup>

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nary negligence is the appropriate standard of liability" in cases involving allegations that directors have "abdicate[d] their managerial responsibilities").

34. See generally 1 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, § 4.6D, at 94.1-94.2; Arsht, *supra* note 25, at 127.

35. Aronson, 473 A.2d at 812.

36. AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 n.9 (Del. Ch. 1986) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) and Aronson, 473 A.2d at 814).

37. Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); see also Arsht, *supra* note 25, at 122 ("a judgment that cannot be sustained on some rational basis falls outside the protection of the business judgment rule").

38. Veasey & Seitz, *supra* note 7, at 1487.

39. Anderson, Clayton, & Co., 519 A.2d at 111 n.9.

40. Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264, 279 n.9 (2d Cir. 1986).

41. Stein v. Orloff, 11 DEL. J. CORP. L. 312, 319 (Del. Ch. 1985), *appeal denied*, No. 352 (Del. Jan. 28, 1986) (LEXIS, States library, Del. file); Saxe v. Brady, 184 A.2d 602, 610, 40

The business judgment rule provides a presumption that each of the rule's five elements has been satisfied, "a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."<sup>42</sup> When a plaintiff is unable to overcome this presumption, the business judgment rule shields corporate decision-makers from judicial second-guessing:

Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to [corporate directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.<sup>43</sup>

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Del. Ch. 474, 482 (1962). Thus, for example, in *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974), the court was faced with a board decision to sell a corporate subsidiary for \$280 million less than its alleged value (\$480 million instead of \$760 million). *Id.* at 601, 607. While the plaintiff could not make a sufficient showing of imprudence in deliberation by the board, *id.* at 615, the court held that "[t]here are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct," *id.* at 610, even where the directors' "method does not appear so bad on its face as to alter the normal legal principles which control." *Id.* at 615.

42. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *quoted in Van Gorkom*, 488 A.2d at 872; *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) and *Ivanhoe Partners v. Newmont Mining Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,552, at 97,487 (Del. Nov. 18, 1987); *see also Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.").

43. *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) (quoting *Pollitz v. Wabash R.R.*, 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912)); *see also* Committee on Corporate Laws, Section of Corporation, Banking and Business Law, American Bar Association, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1603-04 (1978) ("courts have generally refrained from questioning the wisdom of board decisions"); *Reading Co. v. Trailer Train Co.*, No. 7422, slip op. at 10-11 (Del. Ch. Mar. 15, 1984) (LEXIS, States library, Del. file); *Wanvig v. Johnson Controls, Inc.*, No. 663-487, slip op. at 17-18 (Wis. Cir. Ct. Mar. 29, 1985) (emphasis in original). The *Wanvig* court expressed this deference as follows:

[T]he only alternative to the business judgment rule would be to set judges up as super directors whose zeal in running this nation's businesses would be propelled — to use David Reisman's phrase — by the same sort of "omnicompetent arrogance" which has led some judges to supervise the day-to-day operations of a whole host of endeavors outside their own areas of responsibility and expertise. In the long run, that would be a far greater vice than an occasional bad decision made in good faith by those whose business *is* business.



Accordingly, assuming no breach of the duty of loyalty, a plaintiff seeking to establish a breach of fiduciary duty must plead and prove facts sufficient to overcome the presumption that the directors acted with due care.<sup>44</sup> If the plaintiff is able to do so, the burden shifts to the directors to prove that they acted with the requisite degree of care.<sup>45</sup> In Delaware, "director liability is predicated upon concepts of gross negligence" and "gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one" for purposes of overcoming the business judgment rule's presumption.<sup>46</sup>

Finally, of course, even if the presumption is rebutted and the directors are not able to establish that they acted with the requisite degree of care, the plaintiff will ultimately prevail only if he can prove causation and either damages or the necessity for injunctive relief.<sup>47</sup>

## II. The *Van Gorkom* Decision

*Smith v. Van Gorkom* involved a simple holding—gross negligence, therefore no business judgment rule protection—but a complex and unusual set of facts that must be stated at some length in order to understand fully the implications of the court's holding. The following discussion is based upon the majority's statement of the facts it relied upon; significantly, the two dissenting justices' criticism of the majority decision was premised almost entirely upon their objections to the majority's rendition of the facts.<sup>48</sup>

The *Van Gorkom* story begins during the summer of 1980, when Trans Union Corporation's senior management became convinced that the corporation's stock was undervalued (the stock had traded at prices

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44. See *Hanson*, 781 F.2d at 273; *Van Gorkom*, 488 A.2d at 872.

45. See *Hanson*, 781 F.2d at 275-76 (rejecting directors' claims that they reasonably relied on advice of counsel and investment bankers, and that they constituted a "working board" that was "capable of making the swift decisions that it made").

46. *Van Gorkom*, 488 A.2d at 873 (citing *Aronson*, 473 A.2d at 812); see also *supra* note 33 and accompanying text.

47. See *Hanson*, 781 F.2d at 283; *Van Gorkom*, 488 A.2d at 893.

48. See *Van Gorkom*, 488 A.2d at 893-94 (McNeilly, J., dissenting):

The majority opinion reads like an advocate's closing address to a hostile jury. And I say that not lightly. Throughout the opinion great emphasis is directed only to the negative, with nothing more than lip service granted the positive aspects of this case. In my opinion Chancellor Marvel (retired) should have been affirmed. The Chancellor's opinion was the product of well reasoned conclusions, based upon a sound deductive process, clearly supported by the evidence and entitled to deference in this appeal. Because of my diametrical opposition to all evidentiary conclusions of the majority, I respectfully dissent.

See also *id.* at 898 (Christie, J., dissenting) ("I believe that the record taken as a whole supports a conclusion that the actions of the defendants are protected by the business judgment rule.").

ranging from \$24-1/4 to \$39-1/2 per share over a five-year period)<sup>49</sup> due to Trans Union's inability to utilize large tax write-offs.<sup>50</sup> Without consulting the corporation's board of directors, Trans Union's Chairman and Chief Executive Officer, Jerome Van Gorkom, who owned 65,000 shares and was approaching mandatory retirement,<sup>51</sup> suggested to Jay Pritzker a \$55 per share cash-out merger with a company Pritzker controlled.<sup>52</sup> Following several meetings over the course of a week, Pritzker made the offer Van Gorkom had requested. Pritzker insisted, however, that Trans Union's board act on the proposal, which was made on a Thursday, by the following Sunday evening.<sup>53</sup>

That Friday, Van Gorkom called a special board meeting for Saturday, September 20 without advising the directors of the purpose of the meeting.<sup>54</sup> Van Gorkom told his senior management team about the proposed transaction for the first time one hour before the meeting. Notwithstanding a "completely negative" reaction by all but the two officers with whom Van Gorkom had earlier consulted, Van Gorkom proceeded with the board meeting as scheduled.<sup>55</sup>

The board meeting began with a twenty-minute presentation by Van Gorkom, which outlined the terms of the proposed merger. Van Gorkom stated that the free market would judge whether \$55 was a fair price because the proposed agreement permitted Trans Union to receive (but not actively solicit) competing offers for ninety days. He urged that the board give Trans Union's stockholders the opportunity to accept or reject the offer. Van Gorkom never mentioned that he, not Pritzker, was the one who had suggested the \$55 price.<sup>56</sup> One of two officers whom Van Gorkom had consulted prior to September 20 announced his approval.<sup>57</sup> Donald Romans, the corporation's chief financial officer, had opposed the merger at the earlier management meeting, but his recommendation was neither requested by nor given to the board. All that Romans stated at the September 20 board meeting was that he had not learned of the proposal until that morning, that calculations he had done in the past "did not indicate either a fair price for the stock or a valuation of the Company," and that in his opinion "\$55 was 'in the range of a fair

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49. *Id.* at 866 n.5.

50. *Id.* at 864-65.

51. *Id.* at 865-66.

52. *Id.* at 866.

53. *Id.* at 867.

54. *Id.*

55. *Id.* at 867-68.

56. *Id.* at 868.

57. *Id.* at 867, 869.

price,' but 'at the beginning of the range.'"<sup>58</sup> Counsel advised the board that a fairness opinion was not required by law, and that the directors might be sued if they failed to accept the offer.<sup>59</sup>

After about two hours, the directors approved the transaction, and the merger agreement was signed by Van Gorkom at a social event that evening. Neither Van Gorkom nor any other director read the agreement prior to signing.<sup>60</sup> Trans Union announced its "definitive" merger agreement on September 22, omitting any reference to the corporation's limited right to receive higher offers.<sup>61</sup>

The court concluded that, notwithstanding the presumption that directorial judgments are informed judgments, the Trans Union board's September 20 decision to sell the company for \$55 per share did not constitute an exercise of informed business judgment:

The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.<sup>62</sup>

The court acknowledged the directors' right under section 141(e) of the Delaware General Corporation Law to rely upon reports made by corporate officers,<sup>63</sup> but concluded that none of the statements made at the board meeting at which the cash-out merger was approved qualified as "reports" worthy of protection:

At a minimum for a report to enjoy the status conferred by section 141(e), it must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind, reliance. Considering all of the surrounding circumstances—hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever—the directors were duty bound to make reasonable inquiry of Van Gorkom and Romans, and if they had done so, the inadequacy of that upon which they now claim to have relied would have been apparent.<sup>64</sup>

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58. *Id.* at 868-69.

59. *Id.* at 868.

60. *Id.* at 869.

61. *Id.* at 869, 879, 881-82.

62. *Id.* at 874.

63. *Id.* at 874-75.

64. *Id.* at 875. Van Gorkom's 20-minute presentation at that meeting "lacked substance," the court added, "because Van Gorkom was basically uninformed as to the essential provisions of the very document about which he was talking." *Id.*

Indeed, the court suggested, had anyone asked Romans, for example, why he put \$55 at the bottom of his fair price range, the board presumably would have learned the financial officer's view, shared by senior management, that "the timing of the offer was wrong and the offer inadequate."<sup>65</sup> The court also emphasized that no valuation study or other justification for a \$55 per share figure had ever been prepared or even asked for,<sup>66</sup> and that no consideration was given to the possibility of recessing the meeting for a few hours (or requesting an extension of Pritzker's deadline) in order to elicit more information either from management or the company's investment banker, who was already "known to the Board and familiar with Trans Union's affairs."<sup>67</sup>

The court rejected the directors' contention that the magnitude of the premium over market price offered to Trans Union shareholders (39 to 62 percent, depending upon the method of calculation)<sup>68</sup> justified the board's recommendation of the merger on the ground that "the adequacy of a premium is indeterminate unless it is assessed in terms of other competent and sound valuation information that reflects the value of the particular business."<sup>69</sup> The court emphasized the directors' reliance on nothing more than a comparison between the stock's market price—a price the directors admittedly believed was depressed—and the amount of the Pritzker offer.<sup>70</sup>

The court also rejected the directors' contention that the post-September 20 "market test" eliminated the need for the board to perform any other form of fairness test because, according to the directors, "the entire financial community would know that Trans Union was for sale upon the announcement of the Pritzker offer, and anyone desiring to

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65. *Id.* at 877; *see also id.* at 867 n.6 (noting Romans' view that "the price was too low in relation to what [Romans] could derive for the Company in a cash sale").

66. *Id.* at 876. The court noted that neither an outside valuation study nor a fairness opinion by an independent investment banker is required as a matter of law, since "[o]ften insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management." *Id.*

67. *Id.* at 877-78.

68. As described by the court, the methods of calculation were as follows:

[T]he merger price offered to the stockholders of Trans Union represented a premium of 62% over the average of the high and low prices at which Trans Union stock had traded in 1980, a premium of 48% over the last closing price, and a premium of 39% over the highest price at which the stock of Trans Union had traded any time during the prior six years.

*Id.* at 869 n.9.

69. *Id.* at 876.

70. *Id.*

make a better offer was free to do so.”<sup>71</sup> To the contrary, the court concluded, Trans Union was never effectively put up for auction. The court emphasized that the September 20 merger agreement barred Trans Union from actively soliciting offers or furnishing information not already in the public domain to interested parties. Moreover, the court added, the September 22 announcement referred to the corporation’s “definitive agreements” with Pritzker’s company.<sup>72</sup>

The court also rejected Trans Union’s contention that the directors’ “collective experience and sophistication”—Trans Union’s “five ‘outside’ directors included four chief executives of major corporations and an economist who was a former dean of a major school of business and chancellor of a university” with “78 years of combined experience as chief executive officers of major corporations”<sup>73</sup>—was by itself a sufficient basis for finding informed, reasonable deliberation.<sup>74</sup> This claim, the court noted, was undermined by the directors’ “unfounded reliance” on the premium and market test factors as a basis for their decision.<sup>75</sup>

Finally, the court rejected Trans Union’s reliance upon counsel’s advice that failure to accept the Pritzker offer might result in litigation. The court stated that counsel’s recognition that “when faced with difficult or sensitive issues, directors often are subject to suit, irrespective of the decisions they make” constituted neither “legal advice” nor “any valid basis upon which to pursue an uninformed course,” much less a ground upon which directors could “be stampeded into a patently unadvised act.”<sup>76</sup> Rather, the court emphasized, “a board acting within the ambit of the business judgment rule faces no ultimate liability.”<sup>77</sup>

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71. *Id.* at 879.

72. *Id.*

73. *Id.* at 880 n.21; *see also id.* at 894-95 (McNeilly, J., dissenting) (including biographies of each of the directors, and concluding that “[t]hese men knew Trans Union like the back of their hands and were more than well-qualified to make on the spot informed business judgments concerning the affairs of Trans Union including a 100% sale of the corporation”).

74. *Id.* at 880 & n.21.

75. *Id.* at 880.

76. *Id.* at 881.

77. *Id.* The court also held that the directors’ post September 20 actions were not sufficient to “legally rectify and cure the Board’s derelictions.” *Id.* at 881. The court observed that, within days of the signing of the merger agreement, dissent among Trans Union’s senior management became so widespread that Van Gorkom convinced Pritzker to agree to two modifications—authorization for Trans Union’s solicitation as well as receipt of competing offers, and postponement of the shareholder meeting at which the merger would be considered from early January until February 10—which would enhance and extend the “market test” period. The board approved these amendments before they were put in writing. *Id.* at 869-70, 882-83. Two days later, Pritzker delivered proposed amendments to Van Gorkom, who, as on September 20, executed the instrument without reading it. Unlike the amendments authorized by the board, however, the signed amendments provided that Trans Union could terminate its

The court accordingly remanded the case for a determination of the fair value of the Trans Union shares at the time of the board's decision, and for an award of damages to the extent that the fair value exceeded \$55 per share.<sup>78</sup> The case was settled prior to such a determination for \$23.5 million,<sup>79</sup> amounting to approximately \$1.87 per share.<sup>80</sup> The settlement was conditioned upon a \$10 million payment by either Trans Union's or the individual directors' insurance carrier; most of the remaining \$13.5 million was contributed by the Pritzker company that had acquired Trans Union.<sup>81</sup>

### III. Post-*Van Gorkom* Due Care Decisions

Delaware Supreme Court Justice Andrew G.T. Moore, who joined the *Van Gorkom* majority opinion, has stated his view that the case "doesn't stand for new law. The court was just applying old law to egregious facts."<sup>82</sup> Former Delaware Supreme Court Justice William T. Quillen aptly reduced the essence of *Van Gorkom*'s egregious facts to one

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merger agreement with Pritzker only if Trans Union's board had actually entered into a more favorable agreement with a third party (a better *offer* was no longer sufficient) by February 10. The amendments also *shortened* the market test period by requiring that Trans Union file a preliminary proxy statement by December 5 and use its best efforts to mail the statement to shareholders by January 5. *Id.* at 870, 883-84. The court concluded that the directors' approval of these amendments sight unseen exhibited the same gross negligence as their September 20 conduct, *id.* at 884, and that the terms and limitations of the October 10 amendments signed by Van Gorkom ensured that the market test would be "virtually meaningless." *Id.* at 885.

Finally, the court found that an extensive review by the board on January 26 of the entire sequence of events, as developed by that point through pre-trial discovery, and reaffirmation of its September 20 decision, *id.* at 870, 885-87, did not cure the board's earlier derelictions because the board had no legal right to withdraw its approval of the merger at that time. *See id.* at 888:

[U]nder the terms of the October 10 amendment, the Board's only ground for release from its agreement with Pritzker was its entry into a more favorable definitive agreement to sell the Company to a third party. . . . Clearly the Board was not "free" to withdraw from its agreement with Pritzker on January 26 by simply relying on its self-induced failure to have reached an informed business judgment at the time of its original agreement.

78. *Id.* at 893.

79. *See* Smith v. Van Gorkom, No. 6342, slip op. at 3 (Del. Ch. Oct. 11, 1985) (LEXIS, States library, Del. file); *Notice to Former Stockholders of Trans Union Corporation Regarding Settlement and Stipulation and Agreement of Compromise and Settlement*, reprinted in 4 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, at 805-15.

80. Perkins, *Proposed Trans Union Settlement: Directors to Contribute to \$23.5 Million Settlement Fund*, DIRECTORSHIP, Sept. 1, 1985, at 1.

81. *Id.*; Marsh, *Pritzkers Foot Directors' Bill for Trans Union Settlement*, CRAIN'S CHICAGO BUS., Aug. 12, 1985, at 19.

82. Victor, *Rhetoric Is Hot When The Topic Is Takeovers*, LEGAL TIMES, Dec. 23, 1985, at 7.

sentence: "[A] board of directors, without any significant particularized internal or external advanced study, and without prior agenda notice, cannot rely on the protection of the business judgment rule in approving a \$700 million sale of 100% of the corporation in a two hour meeting."<sup>83</sup> The decision, in short, is primarily a result of the facts before the court. The decision's legal significance rests primarily upon its reminder "of the need to comply with the process which should be followed when considering matters of significance to the corporate entity and its shareholders."<sup>84</sup>

This view is confirmed by an examination of the due care decisions handed down since *Van Gorkom*. These cases, most of which involved contests for corporate control, demonstrate that *Van Gorkom* has not changed the courts' traditional application, absent directors' egregious conduct, of the business judgment rule's presumption that directorial conduct is informed and taken in good faith.<sup>85</sup> This fact is particularly significant in light of the courts' view (in Delaware, at least) that a board's duty is "enhanced" in cases involving defensive measures taken in corporate control contests.<sup>86</sup>

This section first reviews post-*Van Gorkom* decisions that find due care and uphold board conduct following full trials or motions for pre-

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83. Quillen, *supra* note 7, at 468; *see also* Leisner, *supra* note 6 ("The moral: Directors who hear the chief executive officer announce with conviction that a proposal acquisition is a good deal simply because he says so are well-advised before they vote too quickly to think a moment about Mr. Van Gorkom and the Trans Union directors.").

84. Block & Hoff, *'Business Judgment': Van Gorkom Revisited*, N.Y.L.J., Aug. 13, 1987, at 5, 6.

85. *See supra* notes 22-43 and accompanying text.

86. The Delaware Supreme Court has held that a board's duty when addressing a pending takeover bid is "enhanced" by the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). This "enhanced" duty dictates "judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Id.* Accordingly, unlike traditional business judgment rule cases where the burden of proof is on the party challenging the transaction, the initial burden lies with the directors, who must show (i) that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (ii) that the defensive measure decided upon was "reasonable in relation to the threat posed." *Id.* at 955. This two-pronged burden may be satisfied, according to the court, "by showing good faith and reasonable investigation," and "such proof is materially enhanced" where the board includes "a majority of outside independent directors." *Id.* Once the board satisfies its burden, the burden of proof shifts back to the plaintiff, who has the ultimate burden of persuasion, and who must demonstrate by a preponderance of the evidence some breach of the directors' fiduciary duties. *Id.* at 958; *see also* *Ivanhoe Partners v. Newmont Mining Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,552, at 97,487 (Del. Nov. 18, 1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 180 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985).

liminary injunctive relief or summary judgment.<sup>87</sup> It then considers post-*Van Gorkom* decisions that address allegations of a lack of due care in the context of motions to dismiss for failure to state a claim (a context in which courts must assume all factual allegations true).<sup>88</sup> Finally, this section addresses post-*Van Gorkom* decisions that find a lack of due care and therefore no business judgment rule protection.<sup>89</sup>

#### A. Cases Finding Due Care and Upholding Board Conduct

As of the end of 1987, twelve post-*Van Gorkom* courts had rejected allegations that challenged board actions did not involve the exercise of due care.<sup>90</sup> These decisions—seven of which followed motions for pre-

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87. See *infra* notes 90-113 and accompanying text.

88. See *infra* notes 114-41 and accompanying text.

89. See *infra* notes 142-266 and accompanying text.

One case, *Keyser v. Commonwealth Nat'l Fin. Corp.* (Commonwealth Nat'l II), No. 85-1853, slip op. (M.D. Pa. June 30, 1987) (LEXIS, Genfed library, Dist. file), fits into none of these categories. In *Commonwealth Nat'l II*, the court denied a motion for summary judgment brought by the defendants in a case alleging that the corporation's board had breached its duty of care on the ground that "the trier of fact will determine whether plaintiffs have proven that the Board failed to act with such care as ordinarily prudent men would have utilized under similar circumstances." *Id.* at 47. The court noted the existence of several facts which, construed in a light most favorable to plaintiffs, could support a finding of a lack of due care, including "the length of the board's deliberations, apparently less than two (2) hours," the lack of any "evidence that any Board member, other than those involved in management, was aware of, much less familiar with," the proposed transaction prior to the board meeting at which the transaction was approved. The court also noted the "unresolvable [issues] on this motion" regarding the awareness by the corporation's outside directors (who constituted 15 of the 17 members of the board) of relevant facts surrounding (1) the existence of an alternative bidder, (2) management's desire not to maximize price, and (3) an investment advisor's beliefs concerning the price accepted by the board and the fairness of a "lock-up" option granted as part of the transaction. See *id.* at 47-67.

90. See *British Printing & Communication Corp. plc v. Harcourt Brace Jovanovich, Inc.*, 664 F. Supp. 1519, 1530-31 (S.D.N.Y. 1987); *Samjens Partners I v. Burlington Indus., Inc.* 663 F. Supp. 614, 624-25 (S.D.N.Y. 1987); *Keyser v. Commonwealth Nat'l Fin. Corp.* (Commonwealth Nat'l I), 644 F. Supp. 1130, 1147-49 (M.D. Pa. 1986); *Terrydale Liquidating Trust v. Barness*, 642 F. Supp. 917, 921-23 (S.D.N.Y. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356-57 (Del. 1985); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985); *Eisenberg v. Chicago Milwaukee Corp.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,544, at 97,443 n.6 (Del. Ch. Dec. 1, 1987); *Lewis v. Leaseway Transp. Corp.*, No. 8720, slip op. at 3 (Del. Ch. June 12, 1987) (LEXIS, States library, Del. file); *Schlossberg v. First Artists Prod. Co., Ltd.*, No. 6670, slip op. at 20-21 (Del. Ch. Dec. 17, 1986) (LEXIS, States library, Del. file); *Mesa Petroleum Co. v. Unocal Corp.*, No. 7997, slip op. at 20-21 (Del. Ch. May 13, 1985) (LEXIS, States library, Del. file), *rev'd on other grounds*, 493 A.2d 946 (Del. 1985); *Tomczak v. Morton Thiokol, Inc.* (Morton Thiokol I), 10 DEL. J. CORP. L. 921, 928 (Del. Ch. 1985); *Edelman v. Phillips Petroleum Co.*, 10 DEL. J. CORP. L. 835, 841-42 (Del. Ch. 1985); see also *In re Beatrice Companies Litigation*, No. 8248, slip op. at 13 (Del. Ch. Apr. 16, 1986) (LEXIS, States library, Del. file) (noting, in the context of approving a proposed settlement, that "history has shown it to be a very rare case in which the judgment of disinterested directors who follow a deliberate process in reaching a business decision will be found to have breached that duty").



liminary injunctive relief,<sup>91</sup> two of which followed motions for summary judgment<sup>92</sup> and three of which followed trials<sup>93</sup>—have focused upon the presence of such factors as action by a majority of outside directors<sup>94</sup> or the creation of a special committee consisting solely of outside directors,<sup>95</sup> consultation with financial advisers and legal counsel<sup>96</sup> retained either by the board as a whole or separately by the outside directors acting as a group<sup>97</sup> (but not by management acting on its own),<sup>98</sup> question-

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*But cf.* *Keyser v. Commonwealth Nat'l Fin. Corp.* (Commonwealth Nat'l II), No. 85-1853, slip op. (M.D. Pa. June 30, 1987) (LEXIS, Genfed library, Dist. file) (denying motion for summary judgment by defendants, discussed *supra* note 89); *Tomczak v. Morton Thiokol, Inc.* (Morton Thiokol II), No. 7861, slip op. (Del. Ch. May 7, 1986) (LEXIS, States library, Del. file) (denying motion to dismiss action, discussed *infra* notes 136-41 and accompanying text).

91. See *Harcourt Brace*, 664 F. Supp. at 1521; *Burlington*, 663 F. Supp. at 616; *Chicago Milwaukee*, [Current] Fed. Sec. L. Rep. (CCH) at 97,440; *Leaseway Transp.*, No. 8720, slip op. at 1; *Unocal*, No. 7997, slip op. at 1; *Morton Thiokol I*, 10 DEL. J. CORP. L. at 923; *Phillips Petroleum*, 10 DEL. J. CORP. L. at 837.

92. See *Commonwealth Nat'l*, 644 F. Supp. at 1132; *First Artists*, No. 6670, slip op. at 20-21.

93. See *Terrydale Liquidation Trust*, 642 F. Supp. at 918; *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1063-64 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985); *Rosenblatt*, 493 A.2d at 936.

94. See *Burlington*, 663 F. Supp. at 624; *Household*, 500 A.2d at 1348 n.2; *Morton Thiokol I*, 10 DEL. J. CORP. L. at 928; *Phillips Petroleum*, 10 DEL. J. CORP. L. at 842.

95. See *Grobow v. Perot*, 526 A.2d 914, 926 (Del. Ch. 1987) (granting motion to dismiss where special committee headed by an outside director recommended transaction), *appeal argued*, No. 133, 1987 (Del. Nov. 3, 1987); *Rabkin v. Philip A. Hunt Chem. Corp.*, No. 7547, slip op. at 16-17, 20 (Del. Ch. Dec. 4, 1986) (granting motion to dismiss where special committee of outside directors recommended transaction).

96. *Harcourt Brace*, 664 F. Supp. at 1524-27, 1530; *Burlington*, 663 F. Supp. at 624-25; *Commonwealth Nat'l*, 644 F. Supp. at 1148-49; *Rosenblatt*, 493 A.2d at 939; *Grobow*, 526 A.2d at 926; *Chicago Milwaukee*, [Current] Fed. Sec. L. Rep. (CCH) at 97,442; *Rabkin*, No. 7547, slip op. at 16, 20; *Unocal*, No. 7797, slip op. at 20-21; *Morton Thiokol I*, 10 DEL. J. CORP. L. at 928; *Phillips Petroleum*, 10 DEL. J. CORP. L. at 845.

97. See *Rabkin*, No. 7547, slip op. at 16.

98. See *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 277 (2d Cir. 1986) (finding lack of due care in case where management was discussing a leveraged buyout with investment advisors and counsel ultimately hired as the board's advisors before the board first met to discuss an unsolicited tender offer, and where confusion regarding whether counsel represented management or the board continued "[e]ven after [the firm] was formally retained by the Board"); *Plaza Sec. Co. v. Fruehauf*, 643 F. Supp. 1535, 1538 (E.D. Mich.) (finding lack of due care in case where management's investment and legal advisers were selected by management to advise special committee of outside directors), *aff'd sub nom.* *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986); *cf.* *Harcourt Brace*, 664 F. Supp. at 1531 ("[t]hat management played an important role in providing information to the board's advisers and in working with them . . . was proper and detracts in no way from the conclusion that the directors exercised due care"). *But cf.* *Chicago Milwaukee*, [Current] Fed. Sec. L. Rep. (CCH) at 97,442 (finding due care in case where financial advisor was retained by corporation's executive committee).

ing of management representatives and financial and legal advisors<sup>99</sup> rather than reliance on conclusory statements by these advisors,<sup>100</sup> and meetings including only outside directors at which questions were formulated.<sup>101</sup> These courts have also focused on pre-meeting distribution of relevant documentation, including summaries of the transaction to be discussed and copies of agreements to be executed,<sup>102</sup> the directors' reading and careful review of such documentation,<sup>103</sup> counsel's review of documentation with the directors,<sup>104</sup> discussion of the proposed transaction at more than one meeting,<sup>105</sup> use of the time the directors have in which

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99. See *Harcourt Brace*, 664 F. Supp. at 1525, 1530; *Commonwealth Nat'l I*, 644 F. Supp. at 1149; *Rosenblatt*, 493 A.2d at 939; see also *Treadway v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980) (pre-*Van Gorkom* case finding due care where directors "armed" their investment advisor with financial questions to evaluate).

100. See *Hanson*, 781 F.2d at 275 (finding lack of due care in case where directors "contented themselves with their financial advisor's conclusory opinion" regarding fair value); *Fruehauf*, 643 F. Supp. at 1538 (finding lack of due care in case where special committee of outside directors "deferred entirely to the judgment of management and its management-selected advisers"); cf. *Commonwealth Nat'l II*, No. 85-1853, slip op. at 55-57 (denying motion for summary judgment in part due to issue of fact regarding sufficiency of questions asked by directors to investment advisor).

101. See *Harcourt Brace*, 664 F. Supp. at 1527 ("non-management directors decided to meet separately to discuss the issues raised in the previous board meetings, apparently at the suggestion of" the chairman of the board and an investment advisor); *Terrydale Liquidating Trust*, 642 F. Supp. at 923 ("independent trustees called a separate meeting pursuant to their own initiative").

102. See *Household*, 500 A.2d at 1349, 1356; *Rosenblatt*, 493 A.2d at 939; see also *Commonwealth Nat'l II*, No. 85-1853, slip op. at 53-54 (denying motion for summary judgment due to existence of issues of fact in case where "pertinent documents," including "175 pages of financial analysis and legal documents" were supplied to directors at the meeting at which the challenged transaction was approved); *Fruehauf*, 643 F. Supp. at 1539 (finding lack of due care in case where special committee of outside directors did not receive any written materials to study "prior to the very day management's proposal was adopted"). But see *Commonwealth Nat'l I*, 644 F. Supp. at 1147 (finding due care notwithstanding plaintiff's contention that "the directors did not receive advance notice that the . . . meeting would be to discuss the [challenged transaction] and, consequently, the directors did not have an opportunity to review beforehand the lengthy financial and legal documents presented to them at the meeting"); *Chicago Milwaukee*, [Current] Fed. Sec. L. Rep. (CCH) at 97,442 & n.3 (finding due care notwithstanding fact that no written materials were made available to directors prior to meeting at which decision was made); *Unocal*, No. 7797, slip op. at 20 (finding due care notwithstanding "some similarities to the *Van Gorkom* facts, most notably the lack of documentation provided to the Unocal board before, during and between its meetings").

103. See *Burlington*, 663 F. Supp. at 624; *Commonwealth Nat'l II*, No. 85-1853, slip op. at 53-54 (discussed *supra* note 102). But see *Commonwealth Nat'l I*, 644 F. Supp. at 1149 (rejecting plaintiff's claim that the directors "should have adjourned to read all of the documents").

104. See *Burlington*, 663 F. Supp. at 624.

105. See *Treadway*, 638 F.2d at 384 (directors "adjourned their deliberations for one week to reflect on the information they had received and to obtain more"); *Harcourt Brace*, 664 F. Supp. at 1530 (five meetings over six days); *Terrydale Liquidating Trust*, 642 F. Supp. at 919, 922 ("[s]everal meetings" and "four days of consideration"); *Unocal*, No. 7797, slip op. at 20

to act,<sup>106</sup> previous consideration of similar or related transactions,<sup>107</sup> and discussion of the proposed transaction's likely effect upon the corporation.<sup>108</sup> Also relevant are the existence, duration and other bona fides of arms-length negotiations with third parties with whom the corporation is entering into the transaction,<sup>109</sup> and the extent of outside director involvement in those negotiations.<sup>110</sup>

A court, of course, looks at all of the facts in the record before it as a whole, and the presence or absence of one or even a majority of the factors listed above is never in and of itself dispositive.<sup>111</sup> Few if any of these factors were present in *Van Gorkom*<sup>112</sup> or any of the post-*Van Gorkom* cases in which the courts have found an absence of due care.<sup>113</sup>

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(board "met for more than nine hours on April 13 and two hours on April 15" prior to April 15 decision); see also *Rabkin*, No. 7547, slip op. at 20 (granting motion to dismiss where merger proposal had been considered "on at least four occasions over a period of approximately six weeks"); cf. *Dynamics Corp. of Am. v. CTS Corp. (CTS II)*, 805 F.2d 705, 707 (7th Cir. 1986) (remanding finding of due care for further consideration notwithstanding "several days of intensive deliberation" by special committee of outside directors).

106. See *Harcourt Brace*, 664 F. Supp. at 1530; *Burlington*, 663 F. Supp. at 625; *Commonwealth Nat'l I*, 644 F. Supp. at 1149 (noting "substantial risk" that "any further delay might result in [merger partner] walking away"); *Terrydale Liquidating Trust*, 642 F. Supp. at 922, 928 ("trustees faced with a partial tender offer replete with potential disadvantages . . . sought out other alternatives under tremendous time pressures" and "selected the best offer available at a time when some immediate action was mandated"); see also *Hanson*, 781 F.2d at 275 (finding lack of due care where directors "manifestly declined to use 'time available for obtaining information' that might be critical"); *Tomczak v. Morton Thiokol, Inc. (Morton Thiokol II)*, No. 7861, slip op. 8 (Del. Ch. May 7, 1986) (LEXIS, States library, Del. file) (denying motion to dismiss allegations of a lack of due care in part because the court found that there was no "emergency" requiring an immediate decision).

107. See *Commonwealth Nat'l*, 644 F. Supp. at 1148; *Terrydale Liquidating Trust*, 642 F. Supp. at 924; *Phillips Petroleum*, 10 DEL. J. CORP. L. at 845; see also *Commonwealth Nat'l II*, No. 85-1853, slip op. at 50, 53 (noting that discussions at earlier meetings made it "inappropriate to focus only" on the meeting at which the challenged transaction was approved, but denying summary judgment in part due to the issue of fact whether "[t]he dispatch with which the Board proceeded at the meeting may have resulted from prior knowledge and familiarity . . . or from undue haste").

108. See *Treadway*, 638 F.2d at 384 (directors requested pro forma balance sheets for the proposed post-merger company); *Harcourt Brace*, 664 F. Supp. at 1526, 1530; see also *Hanson*, 781 F.2d at 276 (finding lack of due care in case where investment advisor offered no opinion as to what kind of company the corporation would be without its core business were a proposed lock-up option to be triggered).

109. See *Burlington*, 663 F. Supp. at 625; *Commonwealth Nat'l*, 644 F. Supp. at 1149; *Rabkin*, No. 7547, slip op. at 17, 20; *Morton Thiokol I*, 10 DEL. J. CORP. L. at 928; *Phillips Petroleum*, 10 DEL. J. CORP. L. at 844-45.

110. See *Burlington*, 663 F. Supp. at 624; *Rabkin*, No. 7547, slip op. at 17, 20.

111. See generally 1 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, § 4.7, at 108 ("there are no hornbook bright lines or litmus tests").

112. See *supra* notes 48-81 and accompanying text.

113. See *infra* notes 142-266 and accompanying text.

## B. Cases Deciding Motions to Dismiss Allegations of an Absence of Due Care

A series of recent Delaware decisions granting motions to dismiss allegations of an absence of due care also illustrate the courts' continued deference following *Van Gorkom* to the business judgment rule's presumption that directorial conduct is the product of an informed decision-making process. These cases are especially significant because courts deciding such motions "must presume all factual allegations of the complaint to be true"<sup>114</sup> and construe the complaint "in the light most favorable to plaintiff."<sup>115</sup> As the United States Supreme Court has put it, a motion to dismiss must be denied "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."<sup>116</sup>

Such motions have been granted in *Lewis v. Honeywell Inc.*,<sup>117</sup> *Grobow v. Perot*<sup>118</sup> and, on all but one claim, *Rabkin v. Philip A. Hunt Chemical Corp.*<sup>119</sup> *Honeywell* involved allegations that three directors, who were high ranking executives of Honeywell, acted in an uninformed manner by rejecting an all-cash offer by Sperry Corporation, which represented a 37 percent premium over market price, and by informing Sperry that they did not wish to pursue negotiations further.<sup>120</sup> The complaint also alleged that these directors acted without consulting the corporation's investment advisor and failed to disclose the offer and its

114. 2A J. MOORE & J. LUCAS, MOORE'S FEDERAL PRACTICE ¶ 12.07[2.-5], at 12-63 (2d ed. 1987).

115. 5 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1357, at 594 (1969). Only "well-pleaded facts," of course, are deemed admitted for purposes of the motion; "legal conclusions, deductions or opinions couched as factual allegations" need not be presumed true. 2A J. MOORE & J. LUCAS, *supra* note 114, § 12.07[2.-5], at 12-63 to 12-64; *see also* C. WRIGHT & A. MILLER, *supra*, § 1357, at 595-96 (courts "accept . . . 'material facts,' 'well pleaded facts' and 'well pleaded allegations,' " but "they do not accept 'legal conclusions,' 'unsupported conclusions,' [or] 'unwarranted inferences.'" (footnotes omitted).

116. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). Different rules apply on a motion to dismiss under FED. R. CIV. P. 23.1 (or comparable state provision) for failure to make a prelitigation demand on a corporation's directors or to plead facts demonstrating demand futility. *See generally* D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 218-44. The courts have held that the demand requirement represents "a marked departure from the 'notice' pleading philosophy of the federal rules," *see, e.g., Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1112 (D. Del.), *aff'd mem.*, 782 F.2d 1026 (3d Cir. 1985); *Good v. Getty Oil Co.*, 514 A.2d 1104, 1106-07 (Del. Ch. 1986), and that a trial court's review of demand futility allegations is discretionary. *See, e.g., Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984); *Aronson v. Lewis*, 473 A.2d 805, 815-16 (Del. 1984).

117. [Current] Fed. Sec. L. Rep. (CCH) ¶ 93,565 (Del. Ch. July 28, 1987).

118. 526 A.2d 914 (Del. Ch. 1987), *appeal argued*, No. 133,1987 (Del. Nov. 3, 1987).

119. No. 7547, slip op. (Del. Ch. Dec. 4, 1986) (LEXIS, States library, Del. file).

120. [Current] Fed. Sec. L. Rep. (CCH) at 97,535, 97,553.

rejection to shareholders.<sup>121</sup> The court acknowledged that the directors' failure to submit the offer to an investment banker tended to support the plaintiff's claim, but held that this fact was by itself legally insufficient to state a claim.<sup>122</sup> The court reasoned as follows:

A rejection of an offer at a premium over market price and a failure to disclose that action to shareholders may or may not be informed. The commission or omission of those acts does not, by itself, establish the degree of enlightenment or ignorance of the decision makers. For example, the Honeywell directors may have rejected Sperry's offer and declined to submit it to the company's investment bankers or to disclose it to shareholders because, based upon their knowledge gathered from other reliable sources, the offer, even if at a premium over market price, was plainly inadequate in relation to the company's intrinsic value.<sup>123</sup>

"What is missing," the court emphasized, are

nonconclusory factual allegations that would establish that the defendant directors rejected (and refused to negotiate) the Sperry offer without having properly informed themselves of the critical facts relating to the merits of that offer or that the directors, while having such information, chose to ignore it in making their decision.<sup>124</sup>

Likewise, in *Grobow v. Perot*,<sup>125</sup> the court granted a motion to dismiss an action alleging that a corporation's directors had failed to exercise informed business judgment in considering a proposed transaction. The court relied upon the fact that the plaintiffs had alleged that a special review committee chaired by an outside director met, considered, and approved a proposed transaction the day before the full board was to meet.<sup>126</sup> The court also relied upon the fact that the plaintiffs had *not* alleged that the committee "failed to consult with and consider the views of financial or legal advisors before recommending to the full Board that it approve the transaction" or that the committee "failed to report its analysis to the full board."<sup>127</sup>

The court in *Rabkin v. Philip A. Hunt Chemical Corp.*<sup>128</sup> similarly rejected an allegation that directors were uninformed. The court based its decision on plaintiffs' pleading that their counsel had met with a special committee of outside directors prior to the committee's making its

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121. *Id.*

122. *Id.* at 97,535.

123. *Id.*

124. *Id.* at 10. The court noted that the plaintiff in *Honeywell* did not allege that the defendants rejected the Sperry offer for entrenchment purposes. *Id.* at 97,535 n.2.

125. 526 A.2d 914 (Del. Ch. 1987), *appeal argued*, No. 133,1987 (Del. Nov. 3, 1987).

126. *Id.* at 919, 926.

127. *Id.* at 926.

128. No. 7547, slip op. (Del. Ch. Dec. 4, 1986) (LEXIS, States library, Del. file).

recommendation regarding a proposed \$20 per share cash-out of minority shareholders.<sup>129</sup> In the court's words, "[a]ssuming, as one must for purposes of this motion, that the Special Committee initially was unaware of the relevant facts, that information was provided by plaintiffs' counsel before the Special Committee recommended the merger."<sup>130</sup>

The *Rabkin* court did not, however, dismiss plaintiffs' contention that the corporation's directors had breached their duty of care by failing to act until after the end of a one-year period during which the corporation's majority shareholder was obligated to pay \$25 per share in any cash-out merger. The majority shareholder had agreed (with the party from whom it had purchased its position) to pay \$25 per share if it purchased all or substantially all of the corporation's remaining outstanding shares during the twelve months following its acquisition of majority status.<sup>131</sup> The majority shareholder, the plaintiffs alleged, had determined to acquire the corporation's remaining outstanding shares "long before" the end of the commitment period but "purposely waited" until after that date in order to avoid paying \$25 per share.<sup>132</sup> The directors, according to plaintiffs, never asked the majority shareholder what its intentions were with respect to the acquisition of minority shares.<sup>133</sup> The court noted that the directors' alleged failure to act during the one year price commitment period could not be judged pursuant to business judgment rule criteria because the rule "may apply to a deliberative decision not to act, but it has no bearing on a claim that directors' inaction was the result of ignorance."<sup>134</sup> The court concluded that although "[w]hether the . . . directors' alleged ignorance caused any injury is questionable," "[i]t may well be that, in the exercise of ordinary care, the . . . directors should have known that the company's controlling shareholder had a one year contractual commitment to the minority stockholders."<sup>135</sup>

A motion to dismiss was also denied in *Tomczak v. Morton Thiokol, Inc. (Morton Thiokol II)*,<sup>136</sup> a case involving Morton Thiokol's sale of one of its divisions to Dow Chemical Company in exchange for cash, 1.4 million Morton Thiokol shares Dow had accumulated on the market,

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129. *Id.* at 16-17, 20-21.

130. *Id.* at 20-21.

131. *Id.* at 2, 10, 16-17.

132. *Id.* at 3.

133. *Id.* at 25.

134. *Id.* at 24; see also *supra* note 26 and accompanying text.

135. *Id.* at 25; see also *Rabkin v. Philip A. Hunt Chem. Corp.*, No. 7547, slip op. at 8-10 (Del. Ch. Dec. 17, 1987) (LEXIS, States library, Del. file) (denying motion for reargument).

136. No. 7861, slip op. (Del. Ch. May 7, 1986) (LEXIS, States library, Del. file).

and a promise by Dow not to purchase any Morton Thiokol stock for ten years.<sup>137</sup> The plaintiffs alleged that (1) only two of Morton Thiokol's twelve directors had "any real notice" of the proposed transaction prior to the board meeting at which it was discussed, (2) the remaining ten directors "had only two short oral presentations to guide them," (3) "no one on the Board questioned, nor were they apprised of," an investment banker's valuation of the assets being sold, (4) "the directors ignored obvious opportunities to obtain a higher price," and (5) there was no "emergency" requiring an immediate decision.<sup>138</sup> The court held that these allegations, "if true, preclude the protection from judicial scrutiny afforded by the business judgment rule."<sup>139</sup>

Interestingly, the same court, in *Tomczak v. Morton Thiokol, Inc. (Morton Thiokol I)*,<sup>140</sup> had denied plaintiffs' request for a preliminary injunction. The court's preliminary injunction opinion relied upon the fact that ten of twelve members of the board were outside directors who acted with the advice of investment bankers and counsel, and emphasized that "[t]here is no evidence that the negotiations were carried out other than at arms-length and they were apparently carefully considered."<sup>141</sup>

The lesson of *Morton Thiokol I* and *Morton Thiokol II*, when taken together, is that a plaintiff may survive a motion to dismiss by pleading facts which, *if true*, would constitute conduct sufficiently egregious to overcome the business judgment rule's presumption of propriety. That plaintiff, however, may have an extremely difficult time obtaining evidence that would prove his allegations once the corporation's directors are given an opportunity to explain what they really did and why.

### C. Cases Finding an Absence of Due Care and Enjoining Board Conduct

Since *Van Gorkom* was decided, a lack of due care and thus an absence of business judgment rule protection for directorial conduct has been found in two Delaware Chancery Court cases—*EAC Industries, Inc. v. Frantz Manufacturing Co.*,<sup>142</sup> and *Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc.*<sup>143</sup>—and four federal court cases—*Hanson Trust PLC v. ML SCM Acquisition, Inc.*,<sup>144</sup> *Edelman v. Fruehauf Corp.*,<sup>145</sup> *Dy-*

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137. *Id.* at 2-3.

138. *Id.* at 7-8.

139. *Id.* at 8.

140. 10 DEL. J. CORP. L. 921 (Del. Ch. 1985).

141. *Id.* at 928.

142. 11 DEL. J. CORP. L. 608 (Del. Ch.), *aff'd on other grounds*, 501 A.2d 401 (Del. 1985).

143. [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,331 (Del. Ch. July 20, 1987).

144. 781 F.2d 264 (2d Cir. 1986).

*namics Corp. of America v. CTS Corp. (CTS I)*,<sup>146</sup> and *Buckhorn, Inc. v. Ropak Corp.*<sup>147</sup> These cases do not reflect new law or a judicial re-examination of the courts' traditional application, absent directors' egregious conduct, of the business judgment rule's presumption that directorial action rests upon an informed decision-making process.

Indeed, even when the factual scenarios underlying these decisions did "not rise to that level of gross negligence found in *Smith v. Van Gorkom*,"<sup>148</sup> the conduct still lacked most if not all of the considerations that have been relied upon by post-*Van Gorkom* courts upholding directorial conduct.<sup>149</sup> Five of the six decisions—*Frantz*, *Sealy*, *Hanson*, *Fruehauf*, and *Buckhorn*—involved board action taken at meetings described as short,<sup>150</sup> late-night<sup>151</sup> and/or telephonic;<sup>152</sup> the sixth case (*CTS I*) involved a longer meeting but still no "cool, dispassionate and thorough" deliberation.<sup>153</sup>

One of the Delaware cases, *Frantz*, involved patently inequitable and entrenchment-motivated conduct following an insurgent's acquisition of 51 percent of the corporation's stock.<sup>154</sup> The other Delaware case, *Sealy*, involved a *concededly* uninformed decision by a subsidiary corporation's board to approve a merger proposed by its parent.<sup>155</sup> This decision was so one sided that the court observed that "if one were setting out to write a textbook study on how one might violate as many fiduciary precepts as possible in the course of a single merger transaction, this case would be a good model."<sup>156</sup>

The four federal court decisions—*Hanson*, *Fruehauf*, *CTS I*, and *Buckhorn*—each involved conduct that preempted the marketplace by

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145. 798 F.2d 882 (6th Cir. 1986).

146. 794 F.2d 250 (7th Cir. 1986).

147. 656 F. Supp. 209 (S.D. Ohio), *aff'd mem.*, 815 F.2d 76 (6th Cir. 1987).

148. *Hanson*, 781 F.2d at 275.

149. See *supra* notes 90-113, 118-30 and accompanying text.

150. See *Buckhorn*, 656 F. Supp. at 230 ("approximately thirty minutes"); Plaza Secs. Co. v. Fruehauf Corp., 643 F. Supp. 1535, 1539 (E.D. Mich.) (special committee recommended transaction "immediately after being advised of the highlights of the transaction on the evening of June 24th" and "[a] meeting of the full board then commenced" and "following twenty minutes of discussion" the transaction was approved), *aff'd sub nom.* Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); *Sealy*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 96,678 ("[t]he 15 to 30 minute meeting had six important agenda items of which the merger was but one"); *Frantz*, 11 DEL. J. CORP. L. at 620 (referring to "absence of discussion").

151. See *Hanson*, 781 F.2d at 275.

152. See *Buckhorn*, 656 F. Supp. at 230; *Sealy*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 96,677.

153. *CTS I*, 794 F.2d at 257.

154. See *infra* notes 168-75 and accompanying text.

155. See *infra* notes 176-86 and accompanying text.

156. *Sealy*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 96,681.



either cutting off an on going and competitive bidding process in favor of a preferred bidder aligned with management (*Hanson* and *Fruehauf*) or putting into place a poison pill designed to end an unwanted acquiror's bid to take over the company (*CTS I* and *Buckhorn*), and which in one case (*CTS I*) was, according to the court, not even "a plausible measure for maximizing shareholder wealth."<sup>157</sup> Each of these four cases involved setting a price for the sale of the corporation or adoption of a poison pill by management or management's representatives, rather than by outside directors or investment advisors working for the board as a whole or for the outside directors.<sup>158</sup> Each of these four cases also involved highly suspect investment advisor presentations, which either omitted information, such as the range of fair value, or which relied exclusively on highly suspect management-prepared forecasts—serious deficiencies that could easily have been detected had the corporation's outside directors asked what these four courts viewed as simple and obviously relevant questions.<sup>159</sup>

An additional thread linking the *Frantz*, *Sealy*, *Hanson*, *Fruehauf*, *CTS I*, and *Buckhorn* decisions is the injunctive relief setting in which they arose.<sup>160</sup> None of these six courts was faced with the prospect of imposing monetary damages upon individual directors—a factor likely to deter many judges and juries who might otherwise be inclined to find an absence of business judgment rule protection.<sup>161</sup> Commentators have suggested that "the business judgment rule may provide greater protection to the decision-maker than to the decision itself,"<sup>162</sup> and that a court's view of directorial conduct "may ultimately depend on whether the case arises as a damage suit against the directors . . . or whether the case arises . . . in an injunction setting."<sup>163</sup> To date, however, the only case law support for this proposition is *Gimbel v. Signal Companies*,

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157. *CTS I*, 794 F.2d at 258.

158. See *supra* notes 97-98, *infra* notes 199-200, 208-19, 224-32, 246-66 and accompanying text.

159. See *supra* notes 99-100, *infra* notes 194-98, 210-15, 225-27, 251-55, 264-66 and accompanying text.

160. See *Hanson*, 781 F.2d at 267; *Fruehauf*, 798 F.2d at 884; *CTS I*, 794 F.2d at 251-52; *Buckhorn*, 656 F. Supp. at 212; *Sealy*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 96,675; *Frantz*, 11 DEL. J. CORP. L. at 610.

161. See Comment, *Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Duty of Care*, 136 U. PA. L. REV. 239, 252 (1987) ("One key to the *Hanson Trust* ruling is the procedural posture of the case: the plaintiffs were appealing the denial of their motion for a preliminary injunction. . . . The *Hanson Trust* court was not faced with the dilemma of imposing ruinous personal damages upon the defendant directors for their breach of the duty of care.").

162. 1 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, § 4.6, at 75.

163. *Id.* § 4.7, at 107-08; see also Veasey & Seitz, *supra* note 7, at 1487.

*Inc.*,<sup>164</sup> a decision in which the court issued a preliminary injunction notwithstanding a finding that the plaintiff had failed to "raise at this stage a reasonable probability that [he] will be able to pierce the 'business judgment' standard."<sup>165</sup>

The *Frantz* and *Sealy* lack of due care holdings involved relatively easy-to-explain sets of facts;<sup>166</sup> by contrast, and like *Van Gorkom*, the *Hanson*, *Fruehauf*, *CTS I*, and *Buckhorn* cases involved relatively complex factual settings that must be stated at some length in order to understand fully these courts' holdings.<sup>167</sup>

(1) *Frantz and Sealy*

a. *EAC Industries, Inc. v. Frantz Manufacturing Co.*<sup>168</sup> involved an unauthorized funding of an Employee Stock Option Plan (ESOP) by the President and Chief Executive Officer of Frantz Manufacturing. The funding occurred the day after EAC Industries had (1) announced its purchase of 51 percent of Frantz's outstanding stock and (2) presented consents replacing one member of the board and amending the corporation's by-laws to require both a quorum of all directors and a unanimous vote of all directors in order for the board to take any action.<sup>169</sup> The effect of the ESOP funding was to reduce EAC's equity interest in Frantz from 51 to 44 percent.<sup>170</sup>

The court rejected, on three separate grounds, Frantz's contention that the ESOP funding was ratified by the board at a meeting held six days later. First, the court held that EAC's consents and adoption of the by-law were valid, thus rendering any board action not approved by all directors—including EAC's nominee—null and void.<sup>171</sup> Second, the court held that "[t]he hastily-called directors meeting . . . conducted from a script prepared by counsel, had an aura of inevitability which was clearly at variance with the requirement that the board members be adequately informed and act after sufficient deliberation."<sup>172</sup> Third, the court held that "[w]hatever may have been the ESOP's original purpose at the time formulated, its funding . . . was primarily for the purpose of

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164. 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974).

165. *Id.* at 615.

166. See *infra* notes 168-86 and accompanying text.

167. See *infra* notes 187-266 and accompanying text.

168. 11 DEL. J. CORP. L. 608 (Del. Ch.), *aff'd on other grounds*, 501 A.2d 401 (Del. 1985).

169. *Id.* at 613-14.

170. *Id.* at 618.

171. *Id.* at 616-18, 620.

172. *Id.* at 620.

diluting EAC's majority control."<sup>173</sup> Corporate action seeking to defeat a takeover effort after control has already been acquired, the court emphasized, constitutes inequitable conduct and is not protected by the business judgment rule.<sup>174</sup>

*Frantz* thus involved a finding of a lack of due care under circumstances so egregious that the court was able to base its decision on the separate and independent grounds of a governing by-law and obvious entrenchment motives. The Delaware Supreme Court affirmed the Chancery Court's decision on these grounds alone, without addressing the board's failure to satisfy the business judgment rule's informed decision requirement.<sup>175</sup>

b. *Sealy Mattress Co. of New Jersey v. Sealy, Inc.*<sup>176</sup> involved a decision by Sealy's directors, each of whom "were employees of and beholden to"<sup>177</sup> either Sealy's parent company, Ohio-Sealy, or Ohio-Sealy's parent, Ohio Mattress,<sup>178</sup> to approve a merger of Sealy into Ohio Sealy.<sup>179</sup> The merger was approved during a fifteen to thirty minute telephone board meeting at which five other important agenda items were discussed.<sup>180</sup> The court found that the merger price was presented by Ohio-Sealy as a *fait accompli*, with no deliberation as to its basis, adequacy or fairness.<sup>181</sup> No investment banker or attorney was consulted.<sup>182</sup> Furthermore, the value of \$27 million and \$45 million antitrust verdicts that Ohio-Sealy (and a company later acquired by Ohio-Sealy) had obtained against Sealy—all prior to Ohio-Sealy's acquisition of majority shareholder status of Sealy<sup>183</sup>—was never addressed, notwithstanding its status as a "critical factor in any assessment of the fairness of the merger price."<sup>184</sup> The court noted un rebutted evidence that these verdicts were worth considerably less than their face amounts and that Ohio-Sealy, after becoming Sealy's controlling shareholder, had instructed Sealy's counsel to end Sealy's challenge of the verdicts.<sup>185</sup> Given this scenario, it is not surprising that Sealy's directors did not dispute that they had ap-

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173. *Id.* at 621.

174. *Id.* at 620-21.

175. *See Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401, 406-09 (Del. 1985).

176. [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,331 (Del. Ch. July 20, 1987).

177. *Id.* at 96,683.

178. *Id.* at 96,674.

179. *Id.* at 96,683.

180. *Id.* at 96,678.

181. *Id.* at 96,677.

182. *Id.* at 96,683.

183. *See id.* at 96,675.

184. *Id.* at 96,677.

185. *Id.* at 96,676 n.8, 96,676-78.

proved the merger in a "completely uninformed" manner; indeed, in their own counsel's words, Sealy's directors "[functioned] in a ministerial capacity to carry out the parent [corporation's] bidding."<sup>186</sup>

(2) Hanson, Fruehauf, CTS I, CTS II, and Buckhorn

a. In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,<sup>187</sup> the Second Circuit Court of Appeals reversed a district court decision<sup>188</sup> and enjoined the exercise of an asset lock-up option<sup>189</sup> granted by SCM Corporation to one of two competing bidders for SCM. Hanson had opened the bidding with a \$60 per share all-cash tender offer, which was followed by a leveraged buy-out offer by SCM's management and Merrill Lynch at \$70 per share, with 85 percent of the consideration to be in cash and 15 percent in debt securities. Hanson responded with a \$72 all-cash bid, and the SCM management-Merrill group raised its bid to \$74 per share, this time 80 percent cash and 20 percent debt securities.<sup>190</sup> Without giving Hanson an opportunity to top this bid,<sup>191</sup> SCM's board granted Merrill an option to buy two of SCM's most attractive businesses for \$350 million and \$80 million, respectively, in the event any party other than Merrill (*i.e.*, Hanson) should acquire more than one-third of SCM's outstanding shares.<sup>192</sup> The district court found that the SCM directors "knew or should have known" that this lock-up option would cause the bidding for control of SCM to "come to an end."<sup>193</sup>

The Second Circuit concluded that the SCM directors' conduct con-

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186. *Id.* at 96,683. The court rejected the directors' defense that as employees of Ohio-Sealy and Ohio Mattress they were entitled (and obliged) to demonstrate their loyalty to their employer. To the contrary, the court emphasized, having assumed directorships of Sealy, these individuals became fiduciaries for all of Sealy's shareholders, including its minority shareholders. *Id.*

187. 781 F.2d 264 (2d Cir. 1986).

188. *Hanson Trust PLC v. SCM Corp.*, 623 F. Supp. 848 (S.D.N.Y. 1985), *rev'd*, 781 F.2d 264 (2d Cir. 1986).

189. An asset lock-up option involves "making some [corporate] asset available to the potential buyer at a price less than those assets would bring in an orderly sale, thereby tending to foreclose further bidding for the target company." *Hanson*, 781 F.2d at 284 (Oakes, J., concurring); *see also id.* at 276 ("the very purpose of an asset option in a takeover context is to give the optionee a bargain as an incentive to bid and an assured benefit should its bid fail"). Asset lock-up options differ significantly from asset sales in which a prize asset sought by a hostile bidder is placed out of its reach at a price which is fair to the corporation, and which does not foreclose bidding. *See, e.g.*, *GM Sub Corp. v. Liggett Group, Inc.*, No. 6155, slip op. at 3-5 (Del. Ch. Apr. 24, 1980).

190. *Hanson*, 781 F.2d at 267, 269-70.

191. *Id.* at 271.

192. *Id.* at 266-67, 270.

193. *Hanson*, 623 F. Supp. at 855.

stituted a breach of their duty of care. The court summarized the critical board meeting as follows:

[T]he SCM directors, in a three-hour late-night meeting, apparently contented themselves with their financial advisor's conclusory opinion that the option prices were "within the range of fair value," although had the directors inquired, they would have learned that Goldman Sachs [their investment banker] had not calculated a range of fairness. There was not even a written opinion from Goldman Sachs as to the value of the two optioned businesses. . . . Moreover, the Board never asked what the top value was or why two businesses that generated half of SCM's income were being sold for one third of the total purchase price of the company . . . or what the company would look like if the options were exercised. . . . There was little or no discussion of how likely it was that the option "trigger" would be pulled, or who would make that decision—Merrill, the Board, or management.<sup>194</sup>

The court emphasized that since Hanson could not acquire stock through its then outstanding tender offer for a full week after the SCM board meeting at which the option was granted, there was certainly no "emergency need for a hasty decision."<sup>195</sup> The court rejected the directors' argument that they had properly relied upon legal and investment banking advice, stating that "directors have some oversight obligations to become reasonably familiar with an opinion, report, or other source of advice before becoming entitled to rely on it":<sup>196</sup>

[t]he Board failed to read or review carefully the various offers and agreements and instead relied on the advisers' descriptions. . . . [T]he directors accepted Goldman Sachs' conclusion that the prices of the optioned assets were fair, without ever inquiring about the range of fair value. . . . The directors did not seek any documents in support of Goldman Sachs' conclusory opinion. . . . Moreover, the fact that [Goldman Sachs] opined . . . that an "orderly sale" could achieve higher prices . . . should have led the directors to investigate, rather than rely baldly upon, the oral opinion as to fairness. Finally, Goldman Sachs offered no opinion as to what kind of company SCM would be without its "core" businesses. On this issue, of which there is no evidence of any inquiry by the directors, there is thus not even a conclusory opinion from its advisors on which the directors plausibly might have relied.<sup>197</sup>

"Indeed," the court pointed out, "given that the very purpose of an asset option in a takeover context is to give the optionee a bargain as an incentive to bid and an assured benefit should its bid fail, . . . a *heightened* duty of care" may in fact have been appropriate.<sup>198</sup> Moreover, the court

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194. *Hanson*, 781 F.2d at 275.

195. *Id.* at 275; *see also id.* at 276.

196. *Id.* at 275.

197. *Id.* at 276.

198. *Id.* (emphasis in original). The court also rejected SCM's defense that its "working

noted, the fact that the transaction had been "proposed by management directors with a not insubstantial potential 15% equity interest in the arrangement" should have prompted the independent directors on SCM's board to take "at least some . . . prophylactic steps."<sup>199</sup> Instead, according to the court, SCM's board delegated broad authority to management, which then "presented . . . various agreements to the SCM directors more or less as *faits accomplis*, which the Board quite hastily approved."<sup>200</sup>

b. In *Edelman v. Fruehauf Corp.*,<sup>201</sup> the Sixth Circuit Court of Appeals upheld a district court breach of fiduciary duty finding.<sup>202</sup> Like *Hanson*, *Fruehauf* involved a bidding contest between an unwanted acquiror and a leveraged buy-out group affiliated with management. Asher B. Edelman began the bidding with an all-cash offer of \$41 per share, which was later increased to \$42 per share. Fruehauf's board rejected this proposal, and Edelman responded by announcing his intention to make a \$44 all-cash tender offer for all Fruehauf shares.<sup>203</sup>

A Fruehauf management-Merrill Lynch leveraged buyout group then offered to purchase 77 percent of Fruehauf's stock for \$48.50 in cash and to issue securities valued at \$48.50 per share to Fruehauf's remaining shareholders.<sup>204</sup> A special committee composed of outside directors approved the proposed transaction without affording Edelman an opportunity to top the bid.<sup>205</sup> Edelman then offered either to structure a similar merger at a price of \$49.50 per share or to make a tender offer for all outstanding Fruehauf shares at \$49.50 per share in cash.<sup>206</sup> The committee rejected both of these offers during a telephone meeting on the

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board" was "already familiar" with the corporation and was thus capable of making such swift decisions: "Given this 'working board's' considerable familiarity with SCM," the court noted, "we must question why it did not find the option prices troublesome in light of the considerable evidence . . . that the optioned assets were worth considerably more than their option prices." *Id.*

199. *Id.* at 277.

200. *Id.* The court observed that "broad delegations of authority are not uncommon and generally are quite proper as conforming to the way that a Board acts in generating proposals for its own consideration. However, when management has a self-interest in consummating an LBO, standard *post hoc* review procedures may be insufficient." *Id.* The court added that an "independent negotiating committee of outside directors . . . certainly would have constituted one appropriate procedure. . . ." *Id.*

201. 798 F.2d 882 (6th Cir. 1986).

202. *Plaza Secs. Co. v. Fruehauf Corp.*, 643 F. Supp. 1535 (E.D. Mich.), *aff'd sub nom. Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986).

203. *Fruehauf*, 798 F.2d at 884.

204. *Id.* at 884-85.

205. *Id.* at 885.

206. *Fruehauf*, 643 F. Supp. at 1540.

ground that Edelman had not "evidence[d] firm financial commitments for the entire transaction"—a requirement not imposed upon the management-Merrill Lynch group.<sup>207</sup>

Both the district court and the Sixth Circuit Court of Appeals concluded that the Fruehauf directors' conduct constituted a breach of their fiduciary duties. The district court harshly criticized the special committee's deference to the judgment of management and management-selected advisors. The court observed that the committee had over the course of five days evaluated the management buyout proposal in four "meetings," three of which were simply telephone updates during which the committee was advised of the status of negotiations.<sup>208</sup> The fourth meeting was held when the committee and the entire board were flown to New York to approve all the necessary documentation for the transaction.<sup>209</sup> The court noted that the committee was unaware either that Merrill Lynch had apparently been willing to pay \$50 per share or that Kidder Peabody, the committee's investment advisor, had determined that the value of the corporation's stock might exceed that \$50 figure.<sup>210</sup> At no time, the court added, did the committee make any attempt to negotiate the terms of the transaction directly with Merrill Lynch or even to give Kidder Peabody "specific instructions" regarding the negotiations that did take place.<sup>211</sup>

The court emphasized that the committee did not receive any written documentation regarding the proposed transaction until it was presented with final drafts at the committee's final meeting, and that these final drafts were explained to, but not read by, the committee members.<sup>212</sup> The court concluded that the committee's "passivity and the superficiality of its review" were "clearly demonstrated"<sup>213</sup> by the committee's failure:

- A. to negotiate, observe negotiations or to suggest that management seek an all-cash transaction, or to consider the possible benefits of any transaction other than the one proposed by management despite the obvious inequities to shareholders of this transaction, particularly to those who would be left as shareholders in a new corporation subordinate to management shareholders;
- B. to either ask for or determine a range of value for the company;
- C. to determine how management was going to obtain . . . \$100 mil-

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207. *Id.* at 1540-41.

208. *Id.* at 1540.

209. *Id.*

210. *Id.*

211. *Id.* at 1538.

212. *Id.* at 1539.

213. *Id.* at 1538.

lion in corporate funds it had committed to purchase the company's shares . . . ;

D. to request any written evaluation or analysis prior to making its recommendation of either the management proposal, or of comparative values of the Edelman Group and management proposals to the shareholders;

E. to attempt to negotiate out the "no-shop" provision;<sup>214</sup>

F. to determine the value of the company before or after the merger, or the value of management's share of that company, as opposed to the shares of those shareholders excluded from the management cash tender offer. . . .<sup>215</sup>

In short, the court stated, "the Committee's review was done in a hurried, last minute atmosphere to meet the needs of management."<sup>216</sup> The Fruehauf directors—including those on the committee and those not on the committee—had "willy-nilly" approved the management buyout, erected barriers to alternative offers, and refused to negotiate two offers from the Edleman group that may have been superior to management's offer.<sup>217</sup> All this, the court thus concluded, constituted a breach of the Fruehauf directors' duties of care and loyalty and a failure to exercise business judgment.<sup>218</sup> The Sixth Circuit affirmed, emphasizing that the evidence "compel[led] the conclusion that the directors simply 'rubber stamped' the management buyout proposal."<sup>219</sup>

c. In *Dynamics Corp. of America v. CTS Corp. (CTS I)*,<sup>220</sup> the Seventh Circuit upheld a district court order<sup>221</sup> enjoining a poison pill adopted by CTS Corporation in response to a hostile tender offer by Dynamics Corporation for 18 percent of CTS's shares (Dynamics already held 9.6 percent), to be followed by a proxy contest for control of the corporation.<sup>222</sup> The pill provided that shareholders would receive one right per share and that, following the acquisition of 15 percent or more of CTS's stock by any person or group, all CTS shareholders other than the acquiror would be entitled to purchase a CTS stock and debenture package for 25 percent of its market value.<sup>223</sup>

The court, in an opinion written by Judge Posner, was highly criti-

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214. See *id.* at 1540 ("[M]anagement entered into a 'no-shop' provision at the insistence of Merrill Lynch which promised that any other offer could only be negotiated to the extent required by fiduciary duty—obviously meaning on a *pro forma* basis if it meant anything.").

215. *Id.* at 1538-39.

216. *Id.* at 1543.

217. *Id.*

218. *Id.*

219. *Fruehauf*, 798 F.2d at 886.

220. 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

221. *Dynamic Corp. of Am. v. CTS Corp.*, 637 F. Supp. 406 (N.D. Ill. 1986).

222. *CTS I*, 794 F.2d at 251; 637 F. Supp. at 407.

223. *CTS I*, 794 F.2d at 258; 637 F. Supp. at 407.



cal of the CTS board's lack of care in adopting the pill. The court emphasized that CTS's management had immediately announced its opposition to Dynamics' bid for control on the very day of Dynamics' announcement "without having studied . . . business and financial implications or even having consulted CTS's outside directors."<sup>224</sup> The court was also concerned that CTS's retention agreement with its investment advisor, Smith Barney, called for a bonus if Dynamics lost the proxy fight, that Smith Barney presented its pill proposal to CTS's board "with an accompanying 'fairness opinion' in which it opined that Dynamics' tender offer was unfair but did not opine on whether the \$43 [per share] price in the offer was fair or unfair," and that the board adopted the pill at the same meeting Smith Barney first presented it.<sup>225</sup> In short, the court concluded:

The tender offer was not evaluated in a cool, dispassionate, and thorough fashion. . . . [T]he insiders on the board, in particular the chairman, decided from the start to block the tender offer, before its ramifications for shareholder welfare were considered; judgment first, trial later, as the Queen of Hearts said in *Alice in Wonderland*. Smith Barney held itself out as a blocker, and would have lost its \$75,000 bonus if it had advised the board that the tender offer was fair and if the end result of this advice had been Dynamics' wresting control of the board from the existing directors.<sup>226</sup>

"How the fairness of the tender offer could be determined without any consideration of the fairness of the offer price," the court added, "is mystifying."<sup>227</sup>

Moreover, Judge Posner wrote, the CTS pill was not even "a plausible measure for maximizing shareholder wealth."<sup>228</sup> The effect of the poison pill, assuming that all rights were exercised and a \$40 per share price, would be to reduce Dynamics' voting power in the election of the board of directors and inflict a substantial capital loss on Dynamics. The triggering of the poison pill would also burden CTS with a large debt—so large, in fact, that some creditors would be entitled to call in their loans—and thereby reduce CTS's net profits substantially. The effect could be to imperil CTS so seriously, the court suggested, that "the whole house of cards might collapse."<sup>229</sup>

The court rejected CTS's defense of its pill "as necessary to protect

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224. *CTS I*, 794 F.2d at 258.

225. *Id.* at 257.

226. *Id.*

227. *Id.*

228. *Id.* at 258.

229. *Id.*

minority shareholders from a disadvantageous 'back-end' transaction" because

[i]f the rationale is to protect minority shareholders, [the pill] should be triggered by a transaction that creates a majority shareholder or that attempts to squeeze out the minority shareholders, and it should give the minority the same price per share as the majority—not a higher price, calculated to kill off the tender, indeed to kill off any tender.<sup>230</sup>

CTS's pill, by contrast, was designed to be triggered much earlier—at 15 percent—and to give CTS's remaining shareholders a higher price than those who had tendered to Dynamics.<sup>231</sup> In short, Judge Posner concluded, CTS's pill "effectively preclude[d] a hostile takeover, and thus allow[ed] management to take the shareholders hostage. To buy CTS, you must buy out its management."<sup>232</sup>

d. *Dynamics Corp. of America v. CTS Corp. (CTS II)*<sup>233</sup> did not involve a finding of a lack of due care. The case illustrates, however, the kinds of process-related questions a court—in this case, the same court that invalidated the *CTS I* pill—may want answered before upholding a poison pill that puts a price tag on a company, especially when adopted in the midst of a battle for corporate control (and after one pill has already been enjoined). Unlike CTS's first pill, the second pill was adopted by a special committee of outside directors. This committee, working with the company's investment advisor, recommended to the board that the company be sold, and that a new poison pill be adopted in order to maximize the sale price.<sup>234</sup> The new pill provided that if any shareholder obtained 28 percent of the company's common stock (Dynamics' interest in CTS following completion of its tender offer would be 27.5 percent), all other shareholders would receive the right to exchange each share of their CTS stock for a \$50 note payable after one year. The pill would remain in effect for one year, but the board could redeem it at any time, and the pill would be cancelled automatically if a \$50 per share cash offer was made for all shares.<sup>235</sup>

The board adopted the committee's recommendation, and Dynamics filed suit once again. This time the district court refused to enjoin CTS's pill,<sup>236</sup> but the Seventh Circuit, in another opinion by Judge Pos-

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230. *Id.* at 259.

231. *Id.*

232. *Id.*

233. 805 F.2d 705 (7th Cir. 1986).

234. *Id.* at 707, 709-10.

235. *Id.* at 707; see also 635 F. Supp. at 1177 & 1179.

236. See *Dynamics Corp. of Am. v. CTS Corp. (CTS II)*, 635 F. Supp. 1174 (N.D. Ill.),

ner, vacated the district court opinion and remanded the case<sup>237</sup> to permit further consideration of three specific issues the Seventh Circuit found unclear. First, the Seventh Circuit questioned the role of CTS's investment adviser—Smith Barney—whose independence had been criticized in *CTS I*. This time Smith Barney was retained by the special committee and an uncontradicted affidavit established that its compensation package did not include a bonus if CTS remained independent. The Seventh Circuit, however, noted a reference in the district court's opinion to an "incentive fee for the white knight strategy" and the absence from the record of a new retention letter.<sup>238</sup> These circumstances, the court concluded, were "troubling"<sup>239</sup> and "suspicious."<sup>240</sup>

Second, the court questioned the board's decision to activate the pill once any shareholder obtained 28 percent—rather than 50 percent—of CTS's shares. The court noted that it was not holding that ownership of 28 percent of any corporation's stock could never "create a 'blocking position' . . . that might justify the use of this percentage to trigger a poison pill," but stated that evidence must justify the corporation's need to set the triggering percentage "below the level that would give a minority shareholder an actual legal right to block decisions taken by the majority."<sup>241</sup>

Third, the court focused on the CTS board's selection of a \$50 per share valuation of the company. The court emphasized that when the "entire premise" underlying a poison pill is "to facilitate the sale of the company, the pill cannot be upheld if the trigger price is an unreasonably high sale price."<sup>242</sup> In the case before it, the court stated, "the method by which the \$50 figure was chosen" was "troublesome."<sup>243</sup> The court observed that the \$50 price was derived by multiplying CTS's expected earnings for the coming year—\$3.23 per share—by a price-earnings mul-

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*later proceedings*, 638 F. Supp. 802 (N.D. Ill.), *vacated and remanded*, 805 F.2d 705 (7th Cir. 1986).

237. *CTS II*, 805 F.2d at 718.

238. *Id.* at 710-11. The court noted that

[t]he scheme of compensation may involve a bonus of some sort for sale to a white knight, even if a "black knight" offers the shareholders more money for their shares. More generally, there is no indication to what extent the amount of compensation is linked to the price at which the company was sold—though some such link might be necessary to align Smith Barney's self-interest with the interests of the shareholders.

*Id.* at 711.

239. *Id.* at 710.

240. *Id.* at 711.

241. *Id.* at 712-13.

242. *Id.* at 714.

243. *Id.*

multiple of 15.5. The court labeled the \$3.23 figure a "wildly extravagant forecast" given the company's reduction less than a month earlier of its 1987 expected earnings from \$1.50 to \$0.89; the 15.5 price-earnings multiple, the court added, did not consider CTS's history of extravagant projections (a factor which would tend to depress the price-earnings multiple when, as in CTS's case, the earnings component is a projection).<sup>244</sup> The court noted that CTS's board had supplied its investment bankers with the \$3.23 per share projection, and that these bankers had accepted that projection "at face value without attempting to verify it."<sup>245</sup>

e. *Buckhorn, Inc. v. Ropak Corp.*<sup>246</sup> also involved a poison pill adopted after the announcement by an unwanted suitor, Ropak Corporation, of an all-cash offer to pay \$4.25 and \$5.875 in cash for all common and preferred shares, respectively, of Buckhorn stock.<sup>247</sup> "[M]otivated primarily by two objectives: 1) to stop the tender offer, although they had not yet received an evaluation of its adequacy; and 2) to provide some security and substantial compensation to top management at a critical point in the company's transition,"<sup>248</sup> Buckhorn's directors quickly approved a series of stock options and severance payments for key management employees, and modified existing option plans to ensure that all options would vest immediately upon any change in control not approved by Buckhorn's board.<sup>249</sup> Only then did the board authorize its investment banking firm, Blunt, Ellis & Loewi (BEL), to evaluate the adequacy of the Ropak offer. All contact with BEL was left in the hands of Buckhorn's management.<sup>250</sup>

Following the directors' approval at their next meeting of the creation of an ESOP, the effect of which "was to make a takeover more difficult by placing a substantial block of shares in the hands of friendly employees and officers,"<sup>251</sup> BEL advised the board that the weight of the

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244. *Id.*

245. *Id.* at 714-15. The court also noted the district court's description of \$50 per share as "an outside high value based substantially on untested, optimistic management projections" in an opinion upholding Dynamics' claim that CTS's board had made misleading representations to CTS's shareholders during the course of the parties' proxy fight. *See id.* at 714 (referring to *Dynamics Corp. of Am. v. CTS Corp.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,765 (N.D. Ill. May 3, 1986).

246. 656 F. Supp. 209 (S.D. Ohio), *aff'd mem.*, 815 F.2d 76 (6th Cir. 1987).

247. *Id.* at 215.

248. *Id.* at 218.

249. *Id.* at 216-17. Several provisions of these "golden parachutes" were ultimately enjoined as breaches of the directors' fiduciary duties. *See id.* at 232-35, 237.

250. *Id.* at 218-19.

251. *Id.* at 220, 223. The court concluded that the ESOP was adopted "in order to thwart Ropak's tender offer and to entrench Buckhorn's management" and enjoined the voting of

evidence supported the conclusion that Ropak's offer was inadequate.<sup>252</sup> The court observed that the record before it did not indicate that the investment bankers explained to the directors, and that the directors did not ask for, the specific facts upon which BEL's opinion was based.<sup>253</sup> The court noted that Ropak's offer fell within the range of valuations determined in three out of four analyses BEL performed and explained to the board; in the fourth analysis, Ropak's offer was within the valuation range for a budget plan prepared prior to Ropak's offer, which estimated projected net income at \$2.83 million, but not for a budget prepared following Ropak's offer which estimated income at \$4 million.<sup>254</sup> Significantly, BEL declined comment on such questions as what price would be adequate, what a range of adequate values would be, and how close Ropak's offer was to being adequate.<sup>255</sup>

Richard Johnston, Buckhorn's Chairman and Chief Executive Officer, then advised the board that a potential white knight had offered \$35 million for Buckhorn's "crown jewel" NesTier division. Johnston, however, valued the NesTier division at \$45 million because he (1) believed, without any formal substantiation, that the division was worth more than \$35 million, (2) assumed that all debts would be paid and that Buckhorn would be able to sell its remaining assets at their book values, and (3) concluded that a "break-up" of the company would yield \$26.5 million. This break-up analysis, however, did not consider deductions for the expenses of liquidation, adjustments for the time value of money, corporate taxes, or taxation of any distribution of cash to shareholders.<sup>256</sup> A second break-up analysis, based on the actual \$35 million offer for NesTier, yielded a \$19 million cash pool for shareholders; the court noted that had taxation considerations been included, that cash pool would have been reduced to less than the amount offered by Ropak.<sup>257</sup>

Buckhorn's directors then voted to reject Ropak's offer, and instructed counsel to prepare a poison pill rights plan for discussion at their next meeting.<sup>258</sup> Eleven days later, the board met by telephone for approximately thirty minutes and adopted the pill.<sup>259</sup> This pill provided

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shares held by this newly created ESOP and the ESOP's acquisition of additional shares. See *id.* at 231-32, 237.

252. *Id.* at 221.

253. *Id.*

254. *Id.*

255. *Id.* at 220-21.

256. *Id.* at 221-22.

257. *Id.* at 222.

258. *Id.*

259. *Id.* at 230.

for the distribution of six rights per common share and ten rights per preferred share. If anyone acquired more than 50 percent but less than 100 percent of Buckhorn's shares without the consent of Buckhorn's board, the rights would entitle their holders to exchange their shares for notes or a new series of preferred stock with a value of \$6 per common share and \$10 per preferred share. The pill would not be triggered if the offeror paid \$6 or more per common share and \$10 or more per preferred share.<sup>260</sup> The court found that the only information Buckhorn's directors relied upon in considering and approving the \$6 and \$10 price triggers was "a conclusory letter from BEL recommending the prices of \$6 and \$10" and an internal memorandum prepared by Carl McLaughlin, Buckhorn's Director of Planning, which "indicate[d] that the price of common shares should be approximately \$6 per share." The court emphasized that, "there was no discussion or inquiry by the directors as to what the bases for these prices were or as to how BEL or McLaughlin arrived at their recommendations."<sup>261</sup>

The court was "mindful that when the directors embarked upon the task of establishing the price of Buckhorn's stock, they 'assumed a great deal of responsibility by providing a substitute for the marketplace which ordinarily would judge the merits of [Ropak's], and any other potential acquiror's, tender offer.'"<sup>262</sup> The court added that if the directors' failure to make an informed decision results in an overpriced poison pill, then the pill becomes a "show-stopper" that prevents shareholders from obtaining a fair market price for their stock. "Thus, it becomes critical that the directors demonstrate that they used due care in arriving at their decision."<sup>263</sup>

Applying these legal standards, the court reasoned that, although it was "imperative" that the directors make an informed decision concerning the value of Buckhorn stock, the evidence indicated that the directors had failed to gather information that was reasonably available and that cast substantial doubt on the reasonableness of the poison pill prices.

Had the directors made a reasonable inquiry into how BEL and McLaughlin arrived at their price recommendations, they would have discovered the following:

- 1) BEL had done little, if any independent analysis of the valuation figure used as the basis for the \$6 and \$10 prices;

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260. *Id.* at 223.

261. *Id.* at 230.

262. *Id.* (quoting *MacAndrews & Forbes v. Revlon, Inc.*, 501 A.2d 1239, 1247 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986)).

263. *Id.* (citing *CTS II*, 805 F.2d at 714).

- 2) BEL relied exclusively on the break-up analysis presented by Johnston . . . as the basis for computing the price of Buckhorn's stock;
- 3) BEL made no attempt to verify or document the assumption that NesTier could be sold for \$45 million or that any of the other assets could be sold at prices assumed by Johnston;
- 4) BEL failed to incorporate into the break-up analysis costs which the directors knew would have to be deducted from Johnston's break-up analysis, such as liquidation costs, tax effects, and the time value of money; and
- 5) McLaughlin's analysis estimated the value of NesTier by using the revised budget projection of \$4 million in net profits for 1987 and multiplying this by a factor of eight. However, the 1987 revised budget projection had never been discussed or approved by the directors and, given Buckhorn's track record of substantially overestimating its budget projections in prior years, is highly questionable. Moreover, McLaughlin used a factor of eight to arrive at a value for NesTier even though Buckhorn's investment banker considered a factor of six as more appropriate. McLaughlin did so upon the instruction of Johnston.<sup>264</sup>

The court concluded that such information "[o]bviously . . . is highly relevant to the assessment of the reasonableness of the prices set in the poison pill," and that each of these facts could have and should have been discovered upon reasonable inquiry" by Buckhorn's directors.<sup>265</sup> The court added that by failing to inquire, the directors had, like the directors in *Van Gorkom*, failed to inform themselves adequately of both their chairman's role in setting the price for the corporation's stock and the material deficiencies in the assumptions and methods used to arrive at such prices.<sup>266</sup>

#### IV. Post-*Van Gorkom* Statutes Protecting Directors from Liability for Monetary Damages

Perhaps the most significant element of the post-*Van Gorkom* environment is the enactment of director-protection statutes by thirty-three states in 1985 through 1987. Most of these statutes, typified by section 102(b)(7) of the Delaware General Corporation Law,<sup>267</sup> authorize shareholder-adopted charter provisions eliminating or limiting a director's liability to the corporation or its stockholders for monetary damages for conduct undertaken in good faith, but which nevertheless constitutes a breach of the duty of care. Five additional statutes increase the standard of directorial culpability required to find liability without the need for an

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264. *Id.* at 230-31.

265. *Id.* at 231.

266. *Id.*

267. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986).

enabling charter provision; one of these statutes also caps the amount of damages for which individual directors may be held liable.<sup>268</sup>

All of these statutes were prompted by a crisis that began during the early-to-mid 1980s in the market for director and officer (D & O) liability insurance. Premiums skyrocketed, deductibles increased at an extraordinary rate, coverage shrank, and many insurance companies terminated their D & O programs. Policy durations became shorter and shorter, the number of exclusions in these policies increased, and nervous insurers utilized early cancellation provisions to bail out of difficult situations.<sup>269</sup> Difficulties in obtaining adequate D & O coverage led many qualified individuals to refuse to serve as corporate directors<sup>270</sup> and has threatened a general overcautiousness in many of those who remain on boards.<sup>271</sup>

One major cause—but by no means the only cause—of these developments was the Delaware Supreme Court's dramatization in *Smith v. Van Gorkom* that directors could really be held personally liable for monetary damages as a result of their conduct as directors.<sup>272</sup> The doomsday predictions that greeted the *Van Gorkom* decision<sup>273</sup> fueled the fears of directors and D & O carriers alike; the Second, Sixth, and

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268. See *infra* notes 277-350 and accompanying text.

269. See D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 328-30; Balotti & Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 6 (1987); Veasey, Finkelstein & Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 400-01 (1987); Smith, *D & O Liability Crisis: Good News, Bad News*, 198 N.Y.L.J., Oct. 29, 1987, at 5, col. 1.

270. See Korn/Ferry International, *Fourteenth Annual Board of Directors Study* (Feb. 25, 1987) (noting that individuals declining invitations to serve on a board of directors for the predominant reason of "increasing legal liability" rose from 2.5% in 1985 to 14.2% in 1986); *The Job Nobody Wants: Outside Directors Find That Risks and Hassles Just Aren't Worth It*, BUS. WK., Sept. 8, 1986, at 56; Lewin, *Director Insurance Drying Up*, N.Y. TIMES, Mar. 7, 1986, at D1, col. 3 ("Just in the last six months, the Control Data Corporation, the Continental Steel Corporation, the Lear Petroleum Corporation, South Texas Drilling and Exploration Inc. and Sykes Datatronics have all lost directors when their insurance ended.").

271. Comment to DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986), reprinted in 5 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, at 14.1; see also Herzel, *Law Should Allow Indemnity for Derivative Suits*, LEGAL TIMES, Mar. 31, 1986, at 11:

Directors already have a bias toward being more cautious than is optimal for society—that is, they take less risk than owner-managers would. Directors have nothing personal to gain from risky behavior. It is, therefore, in the interest of society not to force on directors an added incentive to be too cautious. These undesirable effects are greatest on new, growing companies.

272. See D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 330-31; Balotti & Gentile, *supra* note 269, at 7-8; King, *Director Protection Under Virginia Law*, 20 REV. SEC. & COMM. REG. 129, 130, 132 (1987). Other factors include historically low Directors & Officers insurance premiums and low claims payments, the increased cost of defending litigation, and the rising number of contests for corporate control. See D. BLOCK, N. BARTON & S. RADIN, *supra* note 22, at 330-31; Balotti & Gentile, *supra* note 269, at 6-9.

273. See *supra* notes 5-10 and accompanying text.



Seventh Circuits' granting of injunctive relief in *Hanson*, *Fruehauf*, and *CTS I*, respectively, enhanced these fears.<sup>274</sup> Little if any attention has been paid to the egregious facts present in these cases<sup>275</sup> or the fact that none of these post-*Van Gorkom* cases found a single director liable for monetary damages.<sup>276</sup>

The State of Delaware undertook in June, 1986 to address this problem legislatively by adopting a new Section 102(b)(7) to its General Corporation Law.<sup>277</sup> This statute authorizes the adoption by shareholders of charter provisions eliminating or limiting directorial liability for monetary damages so long as these provisions do not apply to claims for (1) "any breach of the director's duty of loyalty," (2) "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law," (3) unlawful payments of dividends or unlawful stock purchases or redemptions, and (4) transactions from which the director "derived an improper personal benefit."<sup>278</sup>

These exclusions—the precise reach of which will almost certainly be the subject of substantial litigation in coming months and years as plaintiffs attempt to "recharacterize their claims and tailor them to fit one of the excepted categories"<sup>279</sup>—are carefully drafted to reflect the statute's purpose of fostering service by outside directors at a time when many experienced candidates for such positions fear the imposition of personal liability. First, the statute allows shareholders—the owners of the corporation—to determine

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274. See *supra* notes 187-232 and accompanying text.

275. See *supra* notes 142-59, 187-232 and accompanying text.

276. See *supra* notes 160-61 and accompanying text.

277. See Balotti & Gentile, *supra* note 269, at 9-10; Sparks, *Delaware's D & O Liability Law: Other States Should Follow Suit*, LEGAL TIMES, Aug. 18, 1986, at 10.

278. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986).

279. Comment, *supra* note 161, at 273; see also Richards, *Delaware Shareholders May Limit Directors Liability Under New Law*, 195 N.Y.L.J., Aug. 11, 1986, at 35, 45 ("plaintiff's counsel in the future will be careful to couch their complaints for monetary damages in terms of the breach of the director's duty of loyalty, acts or omissions not in good faith and as motivated by an attempt to achieve an improper personal benefit"). The duty of loyalty exception is a particularly likely subject for litigation since the line between the duty of care and the duty of loyalty is not always completely clear. See Herzel, Shepro & Katz, *Next-to-the-last word on Endangered Directors*, 65 HARV. BUS. REV. 38, 43 (1987) ("[w]ith only a little effort, courts could find directors liable for disloyalty where before they would have found them liable for negligence"); Franklin, *D & O Dilemma: NY, Other States Grapple with Liability Issue*, 197 N.Y.L.J., Jan. 29, 1987, at 5, 6 (noting view of one practitioner that "many more cases will be brought under the duty of loyalty theory"); Comment, *supra* note 161, at 273; Note, *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J. L. & PUB. POL'Y 665, 669 (1987). Commentators have also noted the possibility of litigation regarding the statute's applicability to allegations of reckless conduct. See Veasey, Finkelstein & Bigler, *supra* note 269 at 403; Note, *supra*, at 668-69.

whether they wish to adopt a charter amendment pursuant to the statute and thereby enhance the likelihood of attracting and retaining qualified outside independent directors, or whether they wish to retain the threat of personal liability for breach of the fiduciary duty of care as a mechanism for policing the actions of directors, including outside directors.<sup>280</sup>

Second, the statute applies only to directors and not officers, since the drafters did not believe that "the increased perception of risk of personal liability coupled with the unavailability of D & O insurance were sufficient to cause officers, who depend upon a corporation for their livelihood, to resign or refuse to serve."<sup>281</sup> Third, section 102(b)(7) does not affect the availability of equitable remedies such as injunctive relief.<sup>282</sup> Accordingly, the new section does not eliminate the directors' duty of care.<sup>283</sup>

As of the end of 1987, legislation modeled upon the Delaware statute has been enacted in Arizona,<sup>284</sup> Arkansas,<sup>285</sup> California,<sup>286</sup> Colorado,<sup>287</sup> Georgia,<sup>288</sup> Idaho,<sup>289</sup> Iowa,<sup>290</sup> Kansas,<sup>291</sup> Louisiana,<sup>292</sup> Massachusetts,<sup>293</sup> Michigan,<sup>294</sup> Minnesota,<sup>295</sup> Montana,<sup>296</sup> Nevada,<sup>297</sup> New Jersey,<sup>298</sup> New Mexico,<sup>299</sup> New York,<sup>300</sup> North Carolina,<sup>301</sup> Oklahoma,<sup>302</sup> Oregon,<sup>303</sup> Pennsylvania,<sup>304</sup> Rhode Island,<sup>305</sup>

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280. Sparks, *supra* note 277, at 10.

281. *Id.*

282. Comment to DEL. GEN. CORP. LAW § 102(b)(7), reprinted in 5 R. BALOTTI & J. FINKELSTEIN, *supra* note 7, at § 14.1.

283. See Veasey, Finkelstein & Bigler, *supra* note 269, at 403 (noting that the duty of care continues to be "vitality important in injunction and rescission cases and may well be relevant in elections, proxy contests, resignations, and removal contexts").

284. See ARIZ. REV. STAT. ANN. § 10-054(A)(9) (Supp. 1987).

285. See ARK. STAT. ANN. § 64-202B(3) (Supp. 1987).

286. See CAL. CORP. CODE § 204(a)(10) (Deering Supp. 1988).

287. See COLO. REV. STAT. § 7-3-101(1)(u) (1987).

288. See GA. CODE ANN. § 14-2-171(b)(3) (Supp. 1987).

289. See IDAHO CODE § 30-1-54(2) (Supp. 1987).

290. See IOWA CODE §§ 496A.49(13), 491.5(B) (Supp. 1987).

291. See KAN. STAT. ANN. §§ 17-6002(b)(8) (Supp. 1986).

292. See Act of July 3, 1987, Act 261, §§ 1, 3, 1987 La. Sess. Law Serv. 131-32 (West 1987) (to be codified at LA. REV. STAT. ANN. § 12:24(C)(4)).

293. See MASS. GEN. LAWS ANN. ch. 156B, § 13(b)(1-1/2) (West Supp. 1987).

294. See Act of Feb. 27, 1987, Pub. Act No. 1, § 209, 1987 Mich. Legis. Serv. 1-2 (West) (to be codified at MICH. COMP. LAWS § 450.1209(4)).

295. See MINN. STAT. ANN. § 302A.251(4) (West Supp. 1987).

296. See MONT. CODE ANN. § 35-1-202(2)(a)(v) (1987).

297. See NEV. REV. STAT. ANN. § 78.036(1) (Michie 1987).

298. See N.J. REV. STAT. § 14A:2-7(3) (West Supp. 1987).

299. See N.M. STAT. ANN. § 53-12-2(E) (1987).

300. See N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1988).

301. See N.C. GEN. STAT. § 55-7(11) (Michie Supp. 1987).

302. See OKLA. STAT. tit. 18, § 1006(B)(7) (Supp. 1988).

South Dakota,<sup>306</sup> Texas,<sup>307</sup> Utah,<sup>308</sup> Washington,<sup>309</sup> and Wyoming.<sup>310</sup> The Louisiana, Nevada, and New Jersey statutes differ from the Delaware model by providing protection for corporate officers as well as directors.<sup>311</sup> The Nevada statute also differs from the Delaware statute by not specifically including breach of duty of loyalty or receipt of an "improper personal benefit" as exceptions to the authorization of charter provisions eliminating or limiting director liability.<sup>312</sup> In addition, and unlike any other section 102(b)(7)-type statute, the Nevada statute lists "fraud" as an exception to its authorization of exculpatory provisions.<sup>313</sup>

The Georgia statute, like the Nevada statute, does not specifically bar charter provisions protecting directors from liability for breaches of the duty of loyalty, but in place of this exception includes a prohibition upon provisions eliminating or limiting liability for "any appropriation, in violation of [a director's] duties, of any business opportunity of the corporation."<sup>314</sup> The drafters of this provision noted that the Delaware "duty of loyalty" exception "was believed to be an inadequately defined concept," and that Georgia's combination of its "corporate opportunity" exception with the "improper personal benefit" exception taken unchanged from Delaware's statute "reflect[ed] the general principle that a director's liability should not be limited with respect to self-dealing and similar situations in which the director's interests conflict with those of the corporation."<sup>315</sup>

The Arkansas statute, while otherwise identical to the Delaware statute, provides that liability may not be eliminated or limited for acts "creating third party liability to any person or entity other than the corporation or stockholder."<sup>316</sup> The North Carolina statute, by contrast,

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303. See OR. REV. STAT. § 60.047(2)(c) (1987).

304. See 42 PA. CONS. STAT. ANN. § 8364 (Purdon Supp. 1987).

305. See R.I. GEN. LAWS § 7-1.1-48(a)(6) (Supp. 1987).

306. See S.D. CODIFIED LAWS ANN. § 47-2-58.8 (Supp. 1987).

307. See TEX. REV. CIV. STAT. art. 1302-7.06(B) (Vernon Supp. 1988).

308. See UTAH CODE ANN. § 16-10-49.1 (Supp. 1987).

309. See Act of April 29, 1987, ch. 212, § 701, 1987 Wash. Legis. Serv. 341, 343 (West) (to be codified at WASH. REV. CODE § 23A.12.020(d)).

310. See WYO. STAT. § 17-1-202(C) (1987).

311. See Act of July 3, 1987, Act 261 §§ 1, 3, 1987 La. Sess. Law Serv. 131-32 (West 1987) (to be codified at LA. REV. STAT. ANN. § 12.24(C)(4); NEV. REV. STAT. ANN. § 78.036(1) (Michie 1987); N.J. REV. STAT. § 14A:2-7(3), 14A:6-14(4) (West Supp. 1987).

312. NEV. REV. STAT. ANN. § 78.036(1)(a) (Michie 1987).

313. *Id.*

314. GA. CODE ANN. § 14-2-171(b)(3)(i) (Supp. 1987).

315. Note to 1987 Amendment, *printed in* GA. CODE ANN. § 14-2-171(b)(3) (Supp. 1987).

316. ARK. STAT. ANN. § 64-202B(3)(v) (Supp. 1987); *see also* Comment, *supra* note 161, at 276 (noting that third parties, such as bondholders, insurance policy holders, creditors, and

specifies that it permits the limitation or elimination of liability arising out of actions "whether by or in the right of the corporation or otherwise."<sup>317</sup> North Carolina's statute omits the breach of the duty of loyalty exception found in the Delaware statute, and specifies that "the term 'improper personal benefit' does not include a director's compensation or other incidental benefit for or on account of his service as a director, officer, employee, independent contractor, attorney, or consultant of the corporation."<sup>318</sup> Montana's statute differs from the Delaware model by replacing Delaware's exclusion for "intentional misconduct" with an exclusion for "willful misconduct" and "recklessness."<sup>319</sup> New Jersey's statute does not include either "intentional misconduct" or unlawful dividends, stock purchases, and redemptions as exceptions.<sup>320</sup> The Texas statute expands upon Delaware's "improper benefit" exception by specifying that the exception applies "whether or not the benefit resulted from an action taken within the scope of the director's office."<sup>321</sup> The Texas statute also includes an exception for acts for which liability "is expressly provided for by statute."<sup>322</sup> Utah's statute, which is otherwise similar to the Delaware model, permits adoption of provisions eliminating or limiting personal liability in a corporation's bylaws or by resolution, so long as the provision is approved by the same percentage of shareholders as is required to approve a charter amendment.<sup>323</sup> Utah's statute also purports to apply to foreign corporations authorized to transact business in Utah.<sup>324</sup> Washington's statute omits the Delaware model's breach of the duty of loyalty and conduct not in good faith exceptions, and, in place of the improper personal benefit exception, includes an exception for "any transaction from which the director will personally receive a benefit in money, property, or services to which the director is not legally entitled."<sup>325</sup>

The California, New York, New Mexico, and Pennsylvania statutes contain more substantive differences from the Delaware model. California's statute (which, like those in Georgia, Nevada, and Washington,

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parties to other contracts, "have no say in the adoption or maintenance" of liability limiting provisions).

317. N.C. GEN. STAT. § 55-7(11) (Michie Supp. 1987).

318. *Id.*

319. MONT. CODE ANN. § 35-1-202(2)(a)(v)(B) (1987).

320. N.J. REV. STAT. § 14A:A-7(3) (West Supp. 1987).

321. TEX. REV. CIV. STAT. ANN. art. 1302-7.06(B)(3) (Vernon Supp. 1988).

322. *Id.* art. 1302-7.06(B)(4).

323. UTAH CODE ANN. § 16-10-49.1(3) (Supp. 1987).

324. *Id.* § 16-10-49.1(4).

325. Act of April 29, 1987, ch. 212, § 701, 1987 Wash. Legis. Serv. 341, 343 (West) (to be codified at WASH. REV. CODE § 23A.12.020(d)).

does not specifically include breach of the duty of loyalty as an exception<sup>326</sup>) lists several exceptions not included in the Delaware statute. Among these exceptions are (1) acts "a director believes to be contrary to the best interests of the corporation or its shareholders," (2) acts that "show a reckless disregard for the director's duty to the corporation or its shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director's duties, of a risk of serious injury to the corporation or its shareholders," and (3) acts constituting "an unexcused pattern of inattention that amounts to an abdication of the director's duty to the corporation or its shareholders."<sup>327</sup> The California statute, in a manner similar to the Arkansas statute,<sup>328</sup> also specifically limits the reach of charter provisions eliminating or limiting liability to actions "brought by or in the right of the corporation for breach of a director's duties to the corporation and its shareholders," as set forth in the specific section of the California General Corporation Law governing the duties of a director.<sup>329</sup>

New York's statute authorizes the adoption of charter provisions eliminating or limiting a director's liability provided that no such provision eliminates or limits "the liability of any director if a judgment or other final adjudication adverse to him establishes that his acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled"<sup>330</sup> or that his acts "violated" a specific provision of New York's statute barring unlawful dividends, share repurchases, post-dissolution asset distributions and unlawful loans to directors.<sup>331</sup> The New Mexico and Pennsylvania statutes authorize provisions that would eliminate (no reference is made to simply limiting) a director's liability unless his breach of the standard of directorial conduct constitutes, in New Mexico, "negligence, willful misconduct or recklessness,"<sup>332</sup> and in Pennsylvania, "self-dealing, willful misconduct or recklessness."<sup>333</sup> Pennsylvania's statute also provides exceptions for criminal conduct and failure to pay taxes, and requires a

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326. See *supra* notes 312, 314, 325 and accompanying text.

327. CAL. CORP. CODE § 204(a)(10)(A) (Deering Supp. 1988).

328. See *supra* note 316.

329. CAL. CORP. CODE § 204(a)(10)(A) (Deering Supp. 1988) (citing CAL. CORP. CODE § 309).

330. N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1988).

331. *Id.* (citing N.Y. BUS. CORP. LAW § 719).

332. See N.M. STAT. ANN. § 53-12-2(E).

333. 42 PA. CONS. STAT. ANN. § 8364 (Purdon Supp. 1987).

bylaw rather than a charter provision.<sup>334</sup>

Five additional states—Florida,<sup>335</sup> Indiana,<sup>336</sup> Ohio,<sup>337</sup> Virginia,<sup>338</sup> and Wisconsin<sup>339</sup>—have responded to both the D & O crisis and the need for corporations to continue attracting qualified outside directors with statutes that increase the standard of director culpability required to find liability. A corporation need not adopt a charter provision or seek shareholder approval (or both) in order to benefit from these statutes. Rather, the legislatures in these states have determined, as a matter of public policy, that directors of all corporations incorporated under the laws of those states should be shielded from monetary liability to the extent set forth in these statutes.

Florida's statute, for example, provides that a director is not liable for monetary damages for any breach of his duties as a director unless the breach constitutes (1) a violation of criminal law, except when the director "had reasonable cause to believe his conduct was lawful or had no reasonable cause to believe his conduct was unlawful," (2) "a transaction from which the director derived an improper personal benefit, either directly or indirectly," (3) unlawful payments of dividends or unlawful stock purchases or unlawful sales of assets, (4) in a derivative action, "conscious disregard for the best interest of the corporation, or willful misconduct," or (5) in a non-derivative action, "recklessness or an act or omission which was committed in bad faith or with malicious purpose or in a manner exhibiting wanton and willful disregard of human rights, safety, or property."<sup>340</sup>

Indiana's statute provides that a director is not liable for monetary damages for failure to act in compliance with his duties as a director unless the conduct constitutes "willful misconduct or recklessness."<sup>341</sup> Virginia's statute precludes director liability for conduct "in accordance with [the director's] good faith business judgment of the best interests of the corporation."<sup>342</sup>

The Ohio and Wisconsin statutes similarly limit director liability,

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334. *Id.*

335. See Act of June 30, 1987, ch. 87-245, 7, 1987 Fla. Sess. Law Serv. 341-43 (West) (to be codified at FLA. STAT. ANN. § 607.1645).

336. See IND. CODE ANN. § 23-1-35-1(e) (West Supp. 1987).

337. See OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1986).

338. See VA. CODE ANN. §§ 13.1-690A, C (1985).

339. See WIS. STAT. ANN. § 180.307(1) (West Supp. 1987).

340. Act of June 30, 1987, ch. 87-245, 7, 1987 Fla. Sess. Law Serv. 341-43 (West) (to be codified at FLA. STAT. § 607.1645(1)).

341. IND. CODE ANN. § 23-1-35-1(e) (West Supp. 1987).

342. VA. CODE ANN. § 13.1-690 A,C (1985).

but authorize the corporation to "opt out" of this standard by charter provision (as opposed to the Delaware model, which allows corporations to "opt in"). Ohio's statute limits a director's liability for monetary damages unless it is proven, "by clear and convincing evidence," that the act or omission was "undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation."<sup>343</sup> Wisconsin's statute provides directors with immunity from personal liability unless the person asserting such liability proves (1) "a wilful failure to deal fairly with the corporation or its shareholders in connection with a matter in which the director has a material conflict of interest," (2) a violation of criminal law, except when the director had no reasonable cause to believe his conduct was unlawful, (3) "a transaction from which the director had derived an improper personal profit," or (4) wilful misconduct.<sup>344</sup>

Finally, Virginia, in addition to precluding liability for conduct "in accordance with [the director's] good faith business judgment of the best interests of the corporation,"<sup>345</sup> has also adopted legislation that places a ceiling—with or without shareholder approval—upon the amount of damages that can be recovered from officers and directors in actions by shareholders (but not in actions by the corporation) "arising out of a single transaction, occurrence or course of conduct."<sup>346</sup> The ceiling is equal to the greater of \$100,000 or the amount of cash compensation received by an officer or director within the twelve months preceding the challenged conduct,<sup>347</sup> and is inapplicable in cases involving willful misconduct or a knowing violation of law.<sup>348</sup> The corporation may specify a lower ceiling in its articles of incorporation, or, if approved by shareholders, in its bylaws.<sup>349</sup> Some Virginia corporations have reportedly proposed either complete eliminations of liability for monetary damages or caps of \$1.<sup>350</sup>

The most recently published draft of the American Law Institute's (ALI) corporate governance project—*Principles of Corporate Governance: Analysis and Recommendations*—also proposes adoption of a ceiling on the amount of damages that can be recovered against directors

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343. OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1986).

344. WIS. STAT. ANN. § 180.307(1) (West Supp. 1987).

345. VA. CODE ANN. § 13.1-690 A,C (1985); see *supra* note 342 and accompanying text.

346. VA. CODE ANN. § 13.1-692.1A (Supp. 1987).

347. *Id.*

348. *Id.* § 13.1-692.1B.

349. *Id.* § 13.1-692.1A; see also King, *supra* note 272, at 132-33.

350. See Hanks, *Director Liability*, INSIGHTS, Jan. 1988, at 20; Kennedy, *New York Enacts Second Statute; California Proposal Pending*, 8 BUS. LAW. UPDATE 1, 2 (Sept.-Oct. 1987).

and officers for duty of care violations that do not (1) "involve a knowing and culpable violation of law," (2) enable the director or officer (or associates) to receive an "improper" benefit, (3) "show a conscious disregard for the duty of the director or officer to the corporation under circumstances in which the director or officer was aware that his conduct or omission created an unjustified risk of serious injury to the corporation," or (4) "constitute a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant's duty to the corporation."<sup>351</sup> The ALI ceiling, according to this draft, would be equal not to a specified amount, but rather to "an amount that is not disproportionate to the compensation received by the director or officer for serving the corporation during the year of the violation."<sup>352</sup> Unlike Virginia's statute, the ALI's draft does not preclude liability for conduct "in accordance with [the director's] good faith business judgment of the best interests of the corporation," and the ALI's proposed ceiling may not be reduced by the corporation's shareholders. Such a ceiling, it should be noted, poses the risk that judges and juries may be *more* inclined to find directorial liability because such liability would be "limited" rather than potentially overwhelming, and has thus been criticized by many in both the business and legal communities.<sup>353</sup>

These statutory provisions (other than the ALI proposal) are intended to—and do—greatly decrease the possibility of a finding of directorial liability for monetary damages for a duty of care violation.<sup>354</sup> Indeed, the *Van Gorkom* court's finding that the Trans Union directors' conduct, while grossly negligent, nevertheless constituted good faith con-

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351. See *Principles of Corporate Governance: Analysis and Recommendations* § 7.17 (Tent. Draft No. 7, 1987).

352. *Id.*

353. See, e.g., *American Bar Association Section of Litigation's Consolidated Comments to the American Law Institute's Project on "Principles of Corporate Governance: Analysis and Recommendations"* 274-80 (Aug. 1, 1984); *Statement of The Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations"* 64-66 (Feb. 1983); Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624, 642 (1984); Steinberg, *The American Law Institute's Draft Restatement on Corporate Governance: The Business Judgment Rule, Related Principles, and Some General Observations*, 37 U. MIAMI L. REV. 295, 304-05 (1983); Subak, *A Snapshot of the Law Being Carved in Stone*, 42 BUS. LAW. 761, 768-69 (1987). The author notes that his firm, Weil, Gotshal & Manges, is counsel to The Business Roundtable's Corporate Responsibility Task Force in connection with the ALI project.

354. A November 1986 survey by the American Society of Corporate Secretaries reveals that 212 of the Society's members had determined to submit proposals under § 102(b)(7) of the Delaware Corporation Law to their shareholders within six months of the statute's adoption. See Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 95 (1987).



duct<sup>355</sup> presumably would have absolved the directors of liability for monetary damages under section 102(b)(7) of the Delaware statute had Trans Union's shareholders adopted a charter provision eliminating such liability.

## Conclusion

The case law and statutory developments during the three years following the Delaware Supreme Court's landmark decision in *Smith v. Van Gorkom* demonstrate that the business judgment rule's presumption that directorial decisions are made in good faith and are informed decisions<sup>356</sup> remains alive and well. Assuming the facts in *Van Gorkom* to be as they were set forth in that court's majority opinion,<sup>357</sup> the Trans Union directors' conduct—the sale of their shareholders' company for \$700 million solely on the basis of a two-hour meeting without any prior agenda notice and without any particularized study regarding value—was an egregiously inadequate exercise of the directors' responsibilities to Trans Union's shareholders, and certainly not typical of the manner in which most boards conduct business.<sup>358</sup>

Since *Van Gorkom* was decided, the courts have repeatedly rejected due care allegations in cases in which the challenged board conduct did not approach the level of gross negligence present in *Van Gorkom*.<sup>359</sup> The six courts that have found violations of the duty of care since *Van Gorkom*—*Frantz*, *Sealy*, *Hanson*, *Fruehauf*, *CTS I*, and *Buckhorn*—were faced with conduct similar to or at least approaching that found by the *Van Gorkom* court. *Frantz* involved patently inequitable and entrenchment motivated conduct seeking to undo a takeover bid after control had already passed to another group, and *Sealy* involved conduct that even the directors' counsel conceded was uninformed.<sup>360</sup> *Hanson*, *Fruehauf*, *CTS I*, and *Buckhorn* each involved board efforts to preempt the market place. The challenged conduct in *Hanson* and *Fruehauf* cut off on-going and competitive bidding processes in favor of preferred bidders aligned with management. The challenged conduct in *CTS I* and *Buckhorn* put into place poison pills designed to end unwanted takeover bids. In all four of these cases, this defensive conduct was undertaken without studying the terms of the transaction, without asking what these courts viewed

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355. See *Van Gorkom*, 488 A.2d at 873.

356. See *supra* notes 31-34, 42 and accompanying text.

357. See *supra* note 48 and accompanying text.

358. See *supra* notes 49-84 and accompanying text.

359. See *supra* notes 85-86, 90-130 and accompanying text.

360. See *supra* notes 142-56, 168-86 and accompanying text.

as simple and obviously relevant questions and without using time the courts believed was available to the directors.<sup>361</sup> These cases certainly do not reflect a change in the courts' traditional adherence to the business judgment rule's presumption that directorial conduct is the product of good faith and an informed decision-making process.

Moreover, each of the post-*Van Gorkom* findings of a lack of due care have come in the context of requests for injunctive relief rather than in settings when courts faced the prospect of imposing monetary damages upon individual directors. Accordingly, even if the courts were more inclined following *Van Gorkom* to find lapses in directorial decision-making, it is not at all clear that the courts would be inclined to do so in actions where monetary damages were at stake.<sup>362</sup> And, even if the courts were inclined to find such liability, statutes enacted since *Van Gorkom* in Delaware and thirty-two other states ensure that directors may be protected by the corporation's stockholders from the risk of personal liability for conduct undertaken in good faith. This protection may come in the form of the adoption of a charter provision authorized by a statute such as Delaware's section 102(b)(7) or the incorporation (or reincorporation) in a jurisdiction that has heightened the directorial standard of culpability required to find liability.<sup>363</sup>

Perhaps the most enduring effect of *Van Gorkom* is its reminder to directors of the business judgment rule's limits and the importance of board compliance with the process that should be followed when considering fundamental issues affecting the corporation's continued existence as an independent entity. Boards that understand and follow the teachings of *Van Gorkom* and its progeny will find themselves on strong legal grounds.<sup>364</sup>

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361. See *supra* notes 157-59, 187-266 and accompanying text.

362. See *supra* notes 160-65 and accompanying text.

363. See *supra* notes 267-350 and accompanying text.

364. See Block & Hoff, *supra* note 84, at 5; Hansen, *The ALI Corporate Governance Project: of the Duty of Due Care and the Business Judgment Rule, a Commentary*, 41 BUS. LAW. 1237, 1249 n.57 (1986) (noting that the directors in *Van Gorkom* "were held liable, not because they failed to inform themselves to the extent they 'reasonably believed to be appropriate under the circumstances' . . . but rather because they had not . . . taken appropriate steps to inform themselves"); Manning, *supra* note 5, at 4 (*Van Gorkom* "can be fitted . . . into the mainstream of business judgment rule jurisprudence, with its emphasis not on the merits of the decision made by the directors but on the *process* by which the decision was made") (emphasis in original).

## Appendix

### State-by-State Compilation of Post-*Van Gorkom* Due Care Decisions (By Governing Law and in Alphabetical Order)

#### Delaware

Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209 (S.D. Ohio) (finding lack of due care), *aff'd mem.*, 815 F.2d 76 (6th Cir. 1987); EAC Industries, Inc. v. Frantz Manufacturing Co., 11 DEL. J. CORP. L. 608 (Del. Ch.) (finding lack of due care), *aff'd on other grounds*, 501 A.2d 401 (1985); Edelman v. Phillips Petroleum Co., 10 DEL. J. CORP. L. 835 (Del. Ch. 1985) (finding due care); Eisenberg v. Chicago Milwaukee Corp., [Current] Fed. Sec. L. Rep. (CCH) ¶ 93, 544 (Del. Ch. Dec. 1, 1987) (finding due care); Grobow v. Perot, 526 A.2d 914 (Del. Ch. 1987) (granting motion to dismiss allegations of a lack of due care), *appeal argued*, No. 133, 1987 (Del. Nov. 3, 1987); Lewis v. Honeywell Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 93, 566 (Del. Ch. July 28, 1987) (granting motion to dismiss allegations of a lack of due care); Lewis v. Leaseway Transportation Corp., No. 8720, slip op. (Del. Ch. June 12, 1987) (LEXIS, States library, Del. file) (finding due care); Mesa Petroleum Co. v. Unocal Corp., No. 7997, slip op. (Del. Ch. May 13, 1985) (LEXIS, States library, Del. file) (finding due care), *rev'd on other grounds*, 493 A.2d 946 (Del. 1985); Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) (finding due care); Rabkin v. Philip A. Hunt Chemical Corp., No. 7547, slip op. (Del. Ch. Dec. 4, 1986) (LEXIS, States library, Del. file) (denying motion to dismiss all but one of a series of claims alleging a lack of due care); Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985) (finding due care), *motion for reargument denied*, No. 7547, slip op. (Del. Ch. Dec. 17, 1987) (LEXIS, States library, Del. file); Samjens Partners I v. Burlington Industries, Inc., 663 F. Supp. 614 (S.D.N.Y. 1987) (finding due care); Schlossberg v. First Artists Production Co., No. 6670, slip op. (Del. Ch. Dec. 17, 1986) (LEXIS, States library, Del. file) (finding due care); Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,331 (Del. Ch. July 20, 1987) (finding lack of due care); Tomczak v. Morton Thiokol, Inc. (Morton Thiokol I), 10 Del. J. Corp. L. 921 (Del. Ch. 1985) (finding due care); Tomczak v. Morton Thiokol, Inc. (Morton Thiokol II), No. 7861, slip op. (Del. Ch. May 7, 1986) (LEXIS, States library, Del. file) (denying motion to dismiss allegations of a lack of due care).

**Indiana**

Dynamics Corp. of America v. CTS Corp. (CTS I), 794 F.2d 250 (7th Cir. 1986) (finding lack of due care), *aff'g* 637 F. Supp. 406 (N.D. Ill.) (finding lack of due care), *rev'd on other grounds*, 107 S. Ct. 1637 (1987); Dynamics Corp. of America v. CTS Corp. (CTS II), 805 F.2d 705 (7th Cir. 1986) (remanding due care issue), *vacating and remanding*, 638 F. Supp. 802 (N.D. Ill.) (finding due care).

**Michigan**

Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986) (finding lack of due care), *aff'g* Plaza Securities Co. v. Fruehauf Corp., 643 F. Supp. 1535 (E.D. Mich.) (finding lack of due care).

**Missouri**

Terrydale Liquidating Trust v. Barness, 642 F. Supp. 917 (S.D.N.Y. 1986) (finding due care).

**New York**

British Printing & Communication Corp. plc v. Harcourt Brace Jovanovich, Inc., 664 F. Supp. 1519 (S.D.N.Y. 1987) (finding due care); Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264 (2d Cir. 1986) (finding lack of due care), *rev'g* Hanson Trust PLC v. SCM Corp., 623 F. Supp. 848 (S.D.N.Y. 1985) (finding due care).

**Pennsylvania**

Keyser v. Commonwealth National Financial Corp. (Commonwealth National I), 644 F. Supp. 1130 (M.D. Pa. 1986) (finding due care); Keyser v. Commonwealth National Financial Corp. (Commonwealth National II), No. 85-1853, slip op. (M.D. Pa. June 30, 1987) (LEXIS, Genfed library, Dist. file) (denying motion for summary judgment due to issues of fact regarding due care).

